

3-1-1995

## The Theory and Practice of Securities Disclosure

Edmund W. Kitch

Follow this and additional works at: <https://brooklynworks.brooklaw.edu/blr>

---

### Recommended Citation

Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 Brook. L. Rev. 763 (1995).

Available at: <https://brooklynworks.brooklaw.edu/blr/vol61/iss3/3>

This Article is brought to you for free and open access by the Law Journals at BrooklynWorks. It has been accepted for inclusion in Brooklyn Law Review by an authorized editor of BrooklynWorks.

# THE THEORY AND PRACTICE OF SECURITIES DISCLOSURE\*

*Edmund W. Kitch*<sup>†</sup>

## TABLE OF CONTENTS

Introduction .....	764
I. The Concept and Its Influence .....	773
A. Forward-Looking Statements .....	777
B. Segmentation .....	788
1. The FTC Line-of-Business Program .....	793
2. The Securities and Exchange Commission, Continued .....	797
C. Management's Discussion and Analysis ....	799
D. Materiality and the <i>Basic Case</i> .....	816
1. Materiality Defines the Scope of Required Disclosures: Rule 408 .....	819
2. Materiality Defines the Scope of the Insider Trading Prohibition .....	820
3. Materiality Defines the Scope of the Implied Right of Action under Rule 10b-5 .....	820
4. Materiality Is Defined Without Regard to Any Disclosure Obligation, the Presence of Insider Trading, or the Scope of the Implied Cause of Action .....	822
E. Market Valuation of Assets .....	826
F. Identity of Investment Company (Mutual Fund) Managers .....	834

---

\* ©1995 Edmund W. Kitch. All Rights Reserved.

† Joseph M. Hartfield Professor of Law, the University of Virginia. Visiting Professor, Brooklyn Law School (Fall 1995) and Jack N. Pritzker Distinguished Visiting Professor, Northwestern University (Spring 1996). This Article has benefitted from comments by participants at faculty workshops at the law schools of Columbia University, New York University and the University of Virginia. Michael Bevier, Victor Brudney, Mary Ann Case, Michael P. Dooley, Jeffrey Gordon, Dorothy Heyl, Donald Langevoort, Paul G. Mahoney, Roberta Romano, Jack Slain and Michael G. Wolfson provided helpful comments on earlier drafts of the Article.

G. A Look at the Future . . . . .	836
II. The Flaws of Accuracy Enhancement as the Single Goal for Securities Disclosure . . . . .	838
A. Liability Risk . . . . .	840
B. Issuer Interest in Secrecy . . . . .	846
1. The Argument . . . . .	848
2. Case Studies of the Implementation of Accuracy Enhancement as Examples of the Problem . . . . .	857
a. Projections . . . . .	857
b. Segmentation . . . . .	858
c. MD&A and the <i>Caterpillar</i> Case . . . .	859
d. Merger Negotiations: <i>Basic</i> . . . . .	860
e. Market-Value Accounting . . . . .	861
f. Portfolio Managers . . . . .	864
3. The History . . . . .	865
III. Three Applications: Insider Trading, The Scope of the Implied Cause of Action and the Role of Issuer Welfare in Disclosure and Accounting Rules . . . . .	874
A. Insider Trading . . . . .	875
B. The Implied Right of Action under Rule 10b-5 . . . . .	879
C. Accounting and Disclosure Rulemaking . . . .	882
Conclusion . . . . .	887

## INTRODUCTION

The securities laws require issuers of securities sold to the public to disclose significant amounts of prescribed information. This Article is about the goal or goals served by the disclosure that the securities laws require, and the correspondence between the proclaimed goals and actual practice. The dominant view is that the goal of required securities disclosure is to make prices in securities markets more accurate.<sup>1</sup> I call

---

<sup>1</sup> The Advisory Committee on Corporate Disclosure recommended in 1977 that the Securities and Exchange Commission (the "Commission" or the "SEC") adopt the following statement of objectives:

The Commission's function in the corporate disclosure system is to assure the public availability in an efficient and reasonable manner on a timely basis of reliable, firm-oriented information material to informed invest-

this goal "accuracy enhancement."

Accuracy enhancement has been so attractive to those who think about the securities laws that it has never itself been the subject of analysis. It appears as a justification for the securities laws, not as a proposition that is itself contestable. It casts an attractive light on the bureaucrats, lawyers and accountants who minister to the demands of the securities laws. They are not simply clerical drones who compile lengthy and tedious documents containing long lists of numbers. They are servants of economic efficiency; and not just garden-variety servants of efficiency either, but servants of efficiency in the market for capital, the nerve center of a capitalist economy.<sup>2</sup> Perhaps even better from their point of view, it gives them a great deal of work to do.

The plausibility of accuracy enhancement is increased because of the way in which the securities laws divide the

---

ment and corporate suffrage decision-making. The Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct.

ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION 305 (Comm. Print 95-29 1977) [hereinafter "ADVISORY COMMITTEE ON CORPORATE DISCLOSURE"]. Although the Commission never adopted such a formal statement of objectives, the recommendation has influenced Commission practice.

In accounting, the authoritative statement is FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 1: OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES (1978) [hereinafter "FASB 1"], which drew on Chapters 1-3 of FINANCIAL ACCOUNTING STANDARDS BOARD, TENTATIVE CONCLUSIONS ON OBJECTIVES OF FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES (1976), which in turn drew on AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, OBJECTIVES OF FINANCIAL STATEMENTS (1973) [hereinafter "THE TRUEBLOOD REPORT"].

I use accurate rather than efficient to emphasize that the idea is that the securities laws should further accuracy without regard to the cost of doing so. The usage here parallels that of Marcel Kahan, *Securities Law and the Social Costs of "Inaccurate" Stock Prices*, 1991 DUKE L.J. 977 (1992).

<sup>2</sup> For an inventory of the ways in which more accurate prices confer benefits see Kahan, *supra* note 1. Kahan reports: "the compliance effort is rationalized, to a significant degree, by one principal goal of securities laws: to create stock markets in which the market price of a stock corresponds to its fundamental value." Kahan, *supra* note 1, at 979 (citing *Basic, Inc. v. Levinson*, 485 U.S. 224, 246 (1988)); see also H.R. REP. NO. 1383, 73d Cong. 2d Sess. at 11 (1934), reprinted in 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 at 2 (J.S. Ellenberger et al. eds. 1973) [hereinafter "REP NO. 1383"]; and Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 802 (1985).

responsibilities between the legal and accounting professions. The laws, and the lawyers who interpret them, determine when disclosure is required. Professional accounting standards, and the accountants who interpret them, determine how the "hard" numerical data that constitutes the core of the disclosure itself is to be compiled and presented. The theoreticians of the two professions follow the limits of these professional domains. Lawyers writing about the policy objectives of the securities laws discuss why disclosure is required but pay little attention to the substance of the required disclosure. On the other hand, the accountants who write the theoretical accounting literature address the substance of the required disclosure, but do not address why the statutes require disclosure. They think of accounting not as a set of legally mandated practices but as an autonomous professional discipline, whose standards should not be shaped by the fact that the use of the data compiled by accountants is required by a legal regime external to the profession.<sup>3</sup> This division of responsibility means that neither profession is required to confront the question of why the securities laws require the specific disclosures that are actually made. Those few commentators who have undertaken to speak to both professions have found their conclusions ignored, even though many of the arguments made in their work have been influential.<sup>4</sup>

---

<sup>3</sup> Thus the distinction between consensual and mandated accounting was not considered part of the conceptual framework project of the Financial Accounting Standards Board, (the "FASB"). For a recent work which explains accounting standard-setting in consensual terms with no attention to the legally mandated aspect of GAAP, see Ronald R. King & Gregory Waymire, *Accounting Standard-Setting Institutions and the Governance of Incomplete Contracts*, 9 J. OF ACCT. & FIN. 579 (1994).

<sup>4</sup> Most notably, Homer Kripke and George Benston. Kripke, a professor of law, argued that, since the content of required securities disclosure documents is governed by the controlling accounting rules, these rules are an important part of the public regulation, and that the SEC rather than the accounting profession is the appropriate authority to make the accounting rules. Benston, a professor of accounting, argued that the parties to securities transactions could choose the suitable accounting rules, and that compelled disclosure is unnecessary and unwise. Both had excellent arguments for their positions, none of which is seriously responded to in the literature. "Oversimplified" is the most common rejoinder. Yet Benston, who first constructed arguments for required disclosure in order to refute them, has seen his work mined for the arguments in favor of securities regulation. And Kripke, who argued that accounting is too important to be left to the accountants, has seen his work cited for its influence on specific disclosure and account-

Accuracy enhancement is distinct from the concept that people who buy securities should know something about them, and that some of that information should come from the issuer in a form that makes the information credible and the issuer responsible for it. The latter concept is based on the simple notion that persons who put their capital at risk should know, or their agents should know, what they are doing. I call this the prudent-investor concept. The prudent-investor concept says nothing about what the prescribed information should be except to imply that (absent a paternalistic agenda) the information should reflect what buyers want and are willing to pay for. Even with a paternalistic agenda, the concept implies that the information should be that which a sophisticated buyer would require. Accuracy enhancement, on the other hand, has much deeper implications.

The accuracy-enhancement concept in its supportive role floats throughout the history of the securities laws like an attractive genie, darting forward at critical moments to justify securities disclosure, and then darting away.<sup>5</sup> The concept has

---

ing changes. Typical are Loss and Seligman in their discussion of projections. Homer Kripke is described as an "influential critic." 2 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 625 (1989). As to Benston, see the treatment of his work in JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 564-65 (1982). Seligman attributes the formation of the Advisory Committee on Corporate Disclosure to (among other things) the "Benston critiques," while rejecting Benston's conclusions.

<sup>5</sup> A paradigm is a much quoted passage from REP. NO. 1383:

No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgement as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgements of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. Delayed, inaccurate, and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculate on inside information. Despite the tug of conflicting interests and the influence of pow-

now evolved from the role of simply justifying securities law disclosure to determining an agenda for reform. As an impetus for reform, accuracy enhancement influences those charged with administering and interpreting the securities laws. If the purpose of securities disclosure is to make stock prices accurate, then it is necessary to examine the required disclosure to ensure that it contributes to accuracy.<sup>6</sup> Important reforms are justified on the ground that they will contribute to more accurate prices. Yet much remains to be done, for it turns out that although the securities laws have been in force for more than half a century, they have failed to require disclosure of most of the information relevant to the accurate valuation of the issuer's securities.<sup>7</sup>

---

erful groups, responsible officials of the leading exchanges have unqualifiedly recognized in theory at least the vital importance of true and accurate corporate reporting as an essential cog in the proper functioning of the public exchanges. Their efforts to bring about more adequate and prompt publicity have been handicapped by the lack of legal power and by the failure of certain banking and business groups to appreciate that a business that gathers its capital from the investing public has not the same right to secrecy as a small privately owned and managed business. It is only a few decades since men believed that the disclosure of a balance sheet was a disclosure of a trade secret. Today few people would admit the right of any company to solicit public funds without the disclosure of a balance sheet.

REP. NO. 1383, *supra* note 2, at 11.

If the culture of securities regulation were a religion rather than a professional culture, this passage, with its rolling cadences and omnipresent ambiguity could be the religion's recitation of the faith. Note that the passage never actually says "disclosure of all information materially important to investors," leaving it unclear whether the objective is to require the disclosure of all, or only some. For the historical antecedents of required securities disclosure see Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995).

<sup>6</sup> The pioneering work was that of Homer Kripke, who dissented from the report of the Advisory Committee. His book, written over the 1970's, was an extended exploration of the implications of the accuracy enhancement goal. HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* (1979). In his introduction he called the report of the advisory committee a disaster. *Id.* at xviii.

<sup>7</sup> The *Journal of Accountancy* recently reported that Walter P. Schuetze, the new chief accountant of the Securities and Exchange Commission, is fond of saying, "The profession needs to crawl before it can walk and walk before it can run." The *Journal* explained that:

[h]e considers the use of current values for debt and equity securities the crawling part and believes it will be much more difficult to apply current values to fixed assets, such as property, plant and equipment, and to intangibles. . . . Schuetze says "I think getting to market value on fixed

The rise of the accuracy-enhancement concept to a position of influence is related to the rise of another concept in securities regulation: that effective prohibition of trading on inside information is also an important objective of the securities laws. Just as the accuracy-enhancement concept can be found in the early rhetoric of justification, so can the concept that insider trading is bad. But the securities laws as originally passed did not prohibit trading on inside information. It was not until 1961 that the prohibition emerged from the interpretation of general language in the statute.<sup>8</sup> To quote the 1968 *Texas Gulf Sulphur* opinion:

[T]he Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information. . . . The only regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders.<sup>9</sup>

In short, if those in the know can profit by withholding information from the market, they will have an incentive to defeat the accuracy-enhancing objective.<sup>10</sup> Conversely, if the disclosure system succeeds in forcing the disclosure of all information relevant to accurate valuation in a timely fashion, there will be no opportunity for insider trading. And if the disclosure-system provides the information investors need to value the securities, an argument that insider trading is desirable because it is a way in which information can reach the market

---

assets is a long way away. We should concentrate on debt and equity securities and on measuring loan impairment."

Gene R. Barrett, *The SEC's New Chief Accountant Sets Some Clear-Cut Goals*, J. OF ACCOUNT., June 1992, at 102. A more laconic statement is that of John C. Burton & Patricia Fairfield: "[T]he evolution of financial reporting is not complete; users still lack some information that management could provide them for making rational economic decisions." John C. Burton & Patricia Fairfield, *The Role of Financial Information*, in HANDBOOK OF ACCOUNTING AND AUDITING 1 (John C. Burton, et al. eds., 1981), and in HANDBOOK OF ACCOUNTING AND AUDITING 1 (Robert S. Kay & D. Gerald Searfoss eds., 2d ed. 1989).

<sup>8</sup> In re Matter of Cady, Roberts & Co., 40 SEC 907, 912 (1961).

<sup>9</sup> SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848-49 (2d Cir.), cert. denied, 394 U.S. 976 (1968).

<sup>10</sup> JESSE H. CHOPER, JOHN C. COFFEE & C. ROBERT MORRIS, CASES AND MATERIALS ON CORPORATIONS 463 (3d ed. 1989).



becomes superfluous.<sup>11</sup>

This Article argues that although the disclosures mandated by the securities laws have been justified by many commentators on the ground that they serve the goal of enhancing the accuracy of securities prices, and although the goal of accuracy enhancement has had a significant impact on the disclosure-reform agenda over the last quarter century, accuracy enhancement cannot be the only goal that must be served by a rational disclosure system. Both the commentators and the Securities and Exchange Commission ("SEC" or "Commission") have failed to consider the impact of the liability scheme contained in the securities laws themselves and the importance of issuer concerns arising out of the value of information in competitive markets.

Simply put, there are two basic reasons why accuracy enhancement cannot be achieved, one internal to the statutes themselves and the other inherent in the world in which issuers do business. The internal reason is that the securities laws themselves reduce the amount of information that is provided by issuers because they impose significant liability for the production of misinformation. Section 11 of the Securities Act of 1933 (the "Securities Act") imposes strict liability on issuers for any misstatement in the prospectus; imposes liability with a due diligence defense on a wide range of persons associated with a public offering—the underwriters and the officers and directors of the issuer; and provides that the recovery should be for the difference between the offering price and the subse-

---

<sup>11</sup> Cf. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 631 (1984) ("Comparatively [to mandatory disclosure] speaking, derivatively [from insider trading] informed trading is an inefficient capital market mechanism."). See also Joshua Ronen, *The Need for Accounting Objectives In an Efficient Market*, in THE TRUEBLOOD REPORT, *supra* note 1, at 36, 42 ("Insiders possessing information not available to the public or superior forecasting ability are likely to cause the information to be impounded in market prices with less efficiency than if they were to make the information immediately available to the public."). The impact of insider trading on market prices is studied in Lisa K. Meulbroek, *An Empirical Analysis of Illegal Insider Trading*, 47 J. OF FIN. 1661 (1992). According to Meulbroek, "The results reveal that insider trading is associated with immediate price movements and quick price discovery, supporting one component of Manne's and Carlton and Fischel's assertion that insider trading is beneficial." *Id.* at 1663 (referring to HENRY MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966) and Dennis Carlton & Daniel Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983)).

quent market price, subject to a defense that the loss in market value was not caused by the misstatement.<sup>12</sup> Section 12(2), in turn, imposes negligence liability, with the burden of proof reversed.<sup>13</sup> And the courts, through the private right of action they have inferred from Rule 10b-5, have reached nearly the same result for any buyer or seller.<sup>14</sup> This strategy of requiring that information be produced to a "gold standard" is at the heart of the disclosure program as it is traditionally understood. The insight, so accepted in the free speech area, that

---

<sup>12</sup> Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1994) (liability for any untrue statement of a material fact in a prospectus for, among others, the issuer, signing officers, directors and underwriters); Securities Act of 1933 § 11(b)(3), 15 U.S.C. § 77k(b)(3) (1994) (defense for persons other than issuer who sustain the burden of proof that "he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true"); Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (1994) (suit shall be to recover such damages as shall represent the difference between the amount paid for the security and the value thereof as of the time such suit was brought, subject to a defense that if "any portion . . . represents other than the depreciation in value of such security resulting from such part of the registration statement . . . not being true" that portion is not recoverable).

<sup>13</sup> Securities Act of 1933 § 12(2), 15 U.S.C. § 77l(2) (1994) ("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 . . . " and "who did not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable.").

<sup>14</sup> The federal courts have inferred a private cause of action from Rule 10b-5, 17 C.F.R. § 240.10b-5 (1995), which entitled any person injured by a misrepresentation made in connection with the purchase or sale of a security to sue for damages resulting from the misrepresentation. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1975), the Court held that the misrepresentation must be made with "scienter," an ambiguous requirement that has led to considerable confusion in the lower courts, and which in some cases has seemed barely distinguishable from negligence. See Paul S. Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. CORP. L. 179, 180-181 (1986) ("[A] negligence-like standard has crept back into 10b-5 actions, and the subjective focus of the scienter requirement imposed by *Hochfelder* has been undermined."). A recent example is *In re Time Warner Inc. Securities Litigation*, 9 F.3d 259 (2d Cir. 1993), cert. denied, 114 S. Ct. 1397 (1994). A striking example (not involving an issuer) decided shortly after *Hochfelder* is *Rolf v. Eastman Dillon, Inc.*, 424 F. Supp. 1021 (S.D.N.Y. 1977), aff'd and remanded, 570 F.2d 38 (2d Cir.), amended by No. 77-7104 & 77-7124, 1978 WL 4098 (2d Cir. May 22, 1978), cert. denied, 439 U.S. 1039 (1978). Rule 10b-5 actions on behalf of all transactors in the period of the misrepresentation have been greatly aided by the fraud-on-the-market doctrine, which makes class certification automatic. The numerous lower court decisions that adopted the fraud-on-the-market theory were approved by the Supreme Court in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

high standards of liability for the production of erroneous information will, as one of its effects, reduce the production of any information, is unacknowledged in the securities area. But unacknowledged or not, the liability structure of the securities laws reduces the production of information.

The second reason why accuracy enhancement cannot be achieved—the reason inherent in the world in which issuers do business—is that information is power, including the power to compete effectively. In the hands of competitors and others with interests adverse to the issuer, information relevant to accuracy enhancement can be used to harm the issuer. Information is a weapon, and issuers have strong incentives to make disclosures consistent with their success in rivalry with competitors and other adversaries rather than to enhance the accuracy of the prices at which their publicly issued securities are bought and sold. It is no accident that securities documents are opaque.<sup>15</sup>

Part I describes the arguments for accuracy enhancement as the goal of mandated securities disclosure, and the history of the concept's influence on issues of disclosure reform. The issues whose history before the Commission and the courts are traced are: (1) projections, (2) segmentation, (3) management's discussion and analysis ("MD&A") and its application in the SEC's *Caterpillar* decision,<sup>16</sup> (4) materiality and its interpretation in the Supreme Court's *Basic* decision,<sup>17</sup> (5) market-

---

<sup>15</sup> Nor is it because the Commission staff and securities lawyers are hidebound, as A.A. Sommer, Jr. once suggested:

Through the years, there have grown up certain disclosure practices, certain habits of mind, certain stereotyped habits of expression, both on the part of the Commission staff and private practitioners. You could virtually recite the typical prospectus language concerning, for instance, competition. You always said that competition in this industry is intensive and characterized by a large number of competitors, many of whom have greater resources than those of the registrant, etc. . . . You could often predict with precision what a prospectus would say about various problems.

A.A. Sommer, Jr. et al., *New Approaches to Disclosure in Registered Security Offerings—A Panel Discussion*, 28 BUS. LAW. 505, 505 (1973). You still can, and it is not because securities lawyers do not have the imagination and intelligence to challenge or evade Commission requirements successfully when their clients want them to.

<sup>16</sup> Securities and Exchange Act Release No. 33-30532, 1992 LEXIS (March 31, 1992).

<sup>17</sup> 485 U.S. 224 (1988).

value accounting and (6) disclosure of the identity of portfolio managers by investment companies.<sup>18</sup>

Part II explains why the arguments for accuracy enhancement are incomplete. This section illustrates how the imposition of liability for speech and the impact of disclosure on the issuer explains the difficulties encountered by the SEC and the courts in implementing the reforms needed to enhance accuracy. A final section recounts the "lost" history of concerns about secrecy under the Securities Exchange Act of 1934 ("Exchange Act").<sup>19</sup>

Part III then argues that evaluation of the disclosure objective of the securities laws and the Commission's implementation of that objective should be conducted with a more realistic understanding of the fact that accuracy enhancement is only one of a number of conflicting objectives which must be considered: accuracy enhancement as a standard of perfection only encourages, or at least serves as a convenient justification for, costly and needless fine tuning of the disclosure requirements. Finally, the consequences of the arguments made here are connected to other issues in securities regulation: the scope of the prohibition of insider trading, the plausibility of Rule 10b-5 actions, the agenda of accounting and disclosure reform, and the role of the SEC.

## I. THE CONCEPT AND ITS INFLUENCE

The concept that accuracy enhancement should be the goal of disclosure can be argued from a small number of propositions.<sup>20</sup> First, it is socially desirable for securities markets to

<sup>18</sup> Those readers interested only in an overview may sample or simply skip the description of the influence of accuracy enhancement on particular issues and proceed to the second section, again skipping the analysis of particular issues. Those readers with an interest in, or a taste for, the details of securities regulation, are the intended audience for the rest of the Article. Unfortunately, a full appreciation of the difficulties which the accuracy-enhancement concept involves can be gained only by an examination of the problems encountered in its implementation.

<sup>19</sup> 15 U.S.C. §§ 78a-7866 (1994).

<sup>20</sup> There is no place in the literature where the full argument is concisely stated. The following summary contains a number of points that are usually ignored because they are obvious, but they are necessary for a full appreciation of the power of the argument. John C. Coffee, Jr., *Market Failure and the Economic Case for A Mandatory Disclosure System*, 70 VA. L. REV. 717-753 (1984), is the best known summary of the arguments in the legal culture, to judge by its use in

accurately price securities.<sup>21</sup> Second, the accurate price for equity securities is a price that is based on the value of the issuer, because equity securities are a proportional claim on the residual value of the issuer's businesses.<sup>22</sup> Third, the valuation of the issuer depends on correctly predicting future cash flows.<sup>23</sup> Fourth, the public-policy objective of required disclosure under the securities laws is to enable the markets to perform their pricing function in a manner that optimizes the trade-off between the benefits of accurate pricing and the costs incurred by market participants.<sup>24</sup> Fifth, there will tend to be both underinvestment and overinvestment in the activity of

---

both RICHARD W. JENNINGS, ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 229-238 (1992) and in JAMES D. COX, ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 57-59 (1991). Coffee's paper is a comment on Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 717 (1984). The papers were given at a conference sponsored by the University of Virginia Law Review to mark the fiftieth anniversary of the securities laws. The format was Easterbrook and Fischel (anti) and Coffee (pro), although the antis were not very anti that day. As Coffee recognizes with some glee, much of the conceptual structure of his argument can also be found in Easterbrook and Fischel's. The respective arguments are more carefully developed in two earlier documents written by accountants which are largely ignored in the legal literature. See William H. Beaver, *The Nature of Mandated Disclosure*, in ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, *supra* note 1, at 618; GEORGE J. BENSTON, *CORPORATE FINANCIAL DISCLOSURE IN THE UK AND THE USA* 97-165 (1976).

<sup>21</sup> "[I]f we view the securities market as the principal allocative mechanism for investment capital, the behavior of securities prices is important not so much because of their distributive consequences on investors but more because of their effect on allocative efficiency. In this light, it is important not only that the game be fair, but that it be accurate—that is, that capital be correctly priced." Coffee, *supra* note 20, at 734-35. It is the goal of accuracy that Marcel Kahan celebrates. Kahan, *supra* note 1.

<sup>22</sup> This point is assumed, not discussed, in the literature. The finance literature assumes that the price per share multiplied by the number of shares outstanding plus the value of the firm's liabilities should equal the value of the firm, and treats violations of this condition as an anomaly. See Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 906-07 (1988).

<sup>23</sup> "Potential users of financial information most directly concerned with a particular business enterprise are generally interested in its ability to generate favorable cash flows because their decisions relate to amounts, timing, and uncertainties of expected cash flows." FASB I, *supra* note 1, at 11. "[F]inancial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise." FASB I, *supra* note 1, at 17-18.

<sup>24</sup> Coffee emphasizes the need to include the gains from increased allocational efficiency in any calculation of the tradeoffs. Coffee, *supra* note 20, at 736-37.

predicting the accurate price. There will be underinvestment because no actor is able to capture the full benefits of being accurate.<sup>25</sup> There will be overinvestment, in turn, because each market actor will have to identify and analyze the same information separately (and duplicatively) in order to make estimates of value.<sup>26</sup> Sixth, since the universe of information relevant to valuing a business is vast and includes factors as to which the issuer has no clear comparative advantage,<sup>27</sup> and since the process of disclosing information is costly to the issuer, the issuer's obligation to disclose should be focused on the information as to which it does have a comparative advantage—value-relevant information about the issuer's own business.<sup>28</sup> Seventh, since management needs to collect and orga-

---

<sup>25</sup> Coffee, *supra* note 20, at 725-33.

At the collective level, legislation such as the Securities Exchange Act of 1934, which requires continual disclosure of extensive current information by public companies, eliminates the repetitive cost of individual acquisition of information by each analyst. This form of mandatory disclosure collectivizes information acquisition by requiring the originators of information to distribute it and, in some cases, even requiring them to create it.

Gilson & Kraakman, *supra* note 11, at 601.

<sup>26</sup> Coffee, *supra* note 20, at 733-34.

<sup>27</sup> Such factors include interest-rate projections, predictions of the level of economic activity and exchange rate changes.

<sup>28</sup>

[T]he analyst searches for information obtainable from non-issuer sources bearing on the value of a corporate security. Often, this information is critical because the issuer's performance may be substantially dependent on exogenous factors—e.g., interest rates, the behavior of competitors, governmental actions, consumer attitudes, and demographic trends—about which the issuer has no special knowledge or the analyst has superior access.

Coffee, *supra* note 20, at 723-24.

The final comment that the Committee would make about the information in the Commission's system is that it should be firm-oriented. The Advisory Committee is aware that much of the information which influences investment decision-making is macroeconomic in nature. Interest rates, inflation, monetary policy, political issues, all influence the decision to buy a particular security. Yet, for two reasons, little would be gained by requiring Commission disclosure documents to contain this information. First, much of this kind of information is already available on a timely basis, and in a reliable form from other sources. Secondly, the corporation has neither the access to this information nor the expertise in evaluating it to the degree that it materially adds to other sources. It could at most be a disseminator of this information and it is plainly inefficient to have 10,000 companies doing this.

ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, *supra* note 1, at 315-16. An in-

nize the same information in order to manage the business, the cost of requiring the additional step of disclosing it is small.<sup>29</sup>

These propositions are used to argue for the conclusion that the securities laws can and should correct the incentives for both underinvesting and overinvesting in the production of value-relevant information by requiring the issuer to produce the value-relevant, firm-specific information useful to market decisionmakers. It is further argued that this requirement will impose relatively trivial costs on issuers. Beneath such conceptual simplicity are heroic assumptions about the ability of the SEC effectively to identify and induce the production of the correct information, and about the inability of private parties to address these problems through private arrangements.<sup>30</sup> Thus it is important, in assessing their correctness, to examine actual examples of the SEC's and the court's efforts to identify and induce the production of the information which serves the accuracy-enhancement goal.

Examples of subjects which the Commission or the courts have considered in determining what information is relevant to value, and where the influence of accuracy-enhancement can be observed, include the following: (a) forward-looking statements; (b) segmentation; (c) the enhanced requirements for management's discussion and analysis in the annual report; (d) the meaning of materiality; (e) market valuation of assets; and (f) the identity of investment company portfolio managers.

---

vestor might, however, find it illuminating to know what the issuer's management believes to be the case about such exogenous factors, so that she could compare her own beliefs to those of the management.

<sup>29</sup>

Management is as interested in information about assets, liabilities, earnings and related elements as external users and, among its other requirements, generally needs the same kinds of information about those elements as external users. . . . Thus, management is a major user of the same information that is provided by external financial reporting.

FASB I, *supra* note 1, at 14.

<sup>30</sup> Ways in which private parties can address these problems are discussed in Mahoney, *supra* note 5, at 1090-93. It is possible to use similar arguments to reach the opposite conclusion, that is, speech should not be regulated because it is underproduced, and regulation is a cost that will further reduce its production. See Daniel A. Farber, *Free Speech Without Romance: Public Choice and the First Amendment*, 105 HARV. L. REV. 554 (1991).

### A. Forward-Looking Statements

The SEC's historic practice of requiring only the disclosure of historical facts and prohibiting the disclosure of forward-looking information was the first policy to appear distorted when subjected to the lens of accuracy enhancement. The SEC itself first acknowledged as much in 1973; yet, after twenty years of effort, projections remain rare in securities disclosure documents.

An ex-SEC staff member wrote in 1961: "The question will be raised, if the determination of future earnings is the prime task confronting the investor, why not require or permit a direct prediction of such earnings?"<sup>31</sup> The answer was confident:

The answer to this is that the Securities Act, like the hero of 'Dragnet' [a then popular detective series], is interested exclusively in facts. Conjectures and speculations as to the future are left by the Act to the investor on the theory that he is as competent as anyone to predict the future from the given facts.<sup>32</sup>

The question was raised again in the 1969 "Wheat Report," a study of disclosure policies conducted by an internal study group at the Commission. "A number of experienced security analysts suggested to the Study that the Commission should permit 'controlled' projections of sales and earnings in prospectuses filed with the Commission."<sup>33</sup> The response was again dismissive: "A real danger exists, in the Study's judgment, that projections appearing in prospectuses and other documents filed under the securities laws and reviewed by the Commission would be accorded a greater measure of validity by the unsophisticated than they would deserve."<sup>34</sup>

The principal focus of the Wheat Report, however, was not

---

<sup>31</sup> Harry Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 BUS. LAW. 300, 307 (1961). "The intrinsic value of the investment . . . will depend upon the future earnings of the enterprise which will accrue to the security under the terms of the contract which the security represents." *Id.* at 304. Heller cited among other authorities Thorsten Veblen, writing in 1904.

<sup>32</sup> Heller, *supra* note 31, at 307.

<sup>33</sup> SECURITIES AND EXCHANGE COMMISSION, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 95 (1969) [hereinafter "WHEAT REPORT"].

<sup>34</sup> WHEAT REPORT, *supra* note 33, at 96.



the content of disclosure but the occasions when registration was required under the Securities Act. The study had been stimulated by Milton Cohen's article in the *Harvard Law Review*<sup>35</sup> which had proposed relaxing the requirement for the registration of securities under the Securities Act for issuers already subject to the disclosure requirements applicable to public companies. One relaxation of the Securities Act registration requirement that the Wheat Report proposed was to permit the sale, without registration, of shares held by noncontrol persons after a five-year holding period.<sup>36</sup>

When the Commission itself considered the recommendations of the Wheat Report it was unwilling to go so far.<sup>37</sup> The Commission's unwillingness to endorse such a modest reform offended Homer Kripke, who published *The SEC, The Accountants, Some Myths and Some Realities* in 1970 in response.<sup>38</sup> Although the article denied that it was "intended . . . to criticize the performance of the SEC in its duties"<sup>39</sup> it was in fact a wide ranging challenge to much of the received wisdom of securities regulation. In a section entitled "To Perform Its Functions Properly, the SEC Must Reverse Some Deep-Seated Attitudes," Kripke discussed both the issue of current value accounting and earnings projections. Responding to Harry Heller (described as "a former stalwart of the SEC Division of Corporation Finance"), Kripke wrote:

The public is certainly not as able as the management of a corporation to understand the meaning, results and implications of the

---

<sup>35</sup> Milton H. Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340 (1966).

<sup>36</sup> WHEAT REPORT, *supra* note 33, at 25, and Proposed Rule 161(c), WHEAT REPORT, *supra* note 33, at 13, App. VI-1.

<sup>37</sup> The recommendation of the Wheat Report was proposed in Proposal to Adopt Rules Relating to Underwriters, Non-public Offerings and Brokers' Transactions under Sections 2(11), 4(1), 4(2) and 4(4) of the Securities Act of 1933, Securities Act Release No. 33-4997, 1969 WL 8934 (S.E.C.) (Sept. 15, 1969). An alternative and more conservative proposal (the object of Kripke's ire) was proposed in Notice of Proposed Rule 144 Relating to the Definition of the Terms "Underwriter" in Section 2(11) and "Brokers' Transactions" in Section 4(4) of The Securities Act of 1933 and to Rescind Rules 154 and 155 under that Act, Securities Act Release No. 33-5087, 1970 WL 10572 (S.E.C.) (Sept. 22, 1970) [hereinafter "Release 5087"].

<sup>38</sup> Homer Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151 (1970). His discussion of Release 5087 is at 1153-54 and 1160-64.

<sup>39</sup> Kripke, *supra* note 38, at 1152.

complex accounting events which have occurred in any dynamic company or of different rates of improvement or decline in the sales volume and profitability of different product lines. . . . The management, which has the greatest stake in the matter, and which may have spent months of labor in its projections, certainly is in a better position than the public to forecast where the company is going, and its current estimate rendered in good faith is a *fact*.<sup>40</sup>

Kripke also argued that the Commission's policy of forbidding projections hurt the nonprofessional investor. He argued that, in fact, issuers do make projections, and investment professionals learn of these projections and utilize them in making investment decisions. The only people left out are the "little guys" for whom the Commission has always professed a special concern.<sup>41</sup>

Although the thrust of Kripke's arguments was simply that the Commission should permit projections in documents filed with the Commission, he also made it clear that the Commission could do something to improve their quality. He concluded: "Management's estimates, *administratively disciplined*, would be of more value to investors and professionals than the raw facts in which the Commission now drowns them."<sup>42</sup> What this discipline might be he did not discuss.

In 1972 the SEC scheduled hearings to gather information about "the use of estimates, forecasts or projections of earnings and revenues and related subjects [to] develop information for rule-making purposes."<sup>43</sup> Then-Chairman William J. Casey had apparently decided to respond to the critics. In the release announcing the hearings he referred to the British practice of using forecasts, without mentioning that the common law liability standards and procedures of the British law are what

---

<sup>40</sup> Kripke, *supra* note 38, at 1198.

<sup>41</sup>

The professionals get management projections informally through press conferences, speeches to analysts' societies or press releases, and these projections form the basis for professional judgments. Under its present system the SEC precludes the giving of this information equally to all investors through the documents filed with it, and does not subject them to any of the liabilities of the statutes or of administrative scrutiny.

Kripke, *supra* note 38, at 1199.

<sup>42</sup> Kripke, *supra* note 38, at 1201 (emphasis added).

<sup>43</sup> Public Hearings on Estimates, Forecasts or Projections of Economic Performance, Securities Exchange Act Release No. 9844, [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,075 (Nov. 1, 1972).

makes the British practice possible.<sup>44</sup>

In February 1973 the Commission issued a release announcing its "general conclusions."<sup>45</sup> The arguments of the critics were embraced by the Commission. The release stated:

[O]n the basis of the information obtained through the hearings and on the basis of staff recommendations and its experience in administering the securities laws, the Commission has now determined that changes in its present policies with regard to use of projections would assist in the protection of investors and would be in the public interest. The Commission recognizes that projections are currently widespread in the securities markets and are relied upon in the investment process. Persons invest with the future in mind and the market value of a security reflects the judgments of investors about the future economic performance of the issuer. Thus projections are sought by all investors, whether institutional or individual. The Commission is concerned, however, that all investors do not have equal access to this material information.<sup>46</sup>

No implementing regulations were proposed. The Commission, however, did insist that it would not require projections.<sup>47</sup>

Proposed implementing regulations followed in 1975.<sup>48</sup> Even now, twenty years later, one can imagine an SEC staff member muttering as he fine tuned the proposal: "They want projections, we will give them projections. Reliable projections." The projection proposal undertook to implement the same approach to disclosure as is required for any other kind of information by the securities laws. The information disclosed

---

<sup>44</sup> *Id.* Chairman Casey's reference to the example of British practice may have been suggested by David C. Damant, *A Note on Practice in the United Kingdom: Financial Forecasting by Companies*, FIN. ANALYSTS J., Sept.-Oct. 1972, at 44, which reported that British disclosure documents did contain forecasts.

<sup>45</sup> Disclosure of Projections of Future Economic Performance, Exchange Act Release No. 9984, 1973 WL 12099 (S.E.C.) (Feb. 2, 1973).

<sup>46</sup> *Id.* at 1.

<sup>47</sup> "The Commission has never required a company to publicly disclose its projections and does not intend to do so now." *Id.*

<sup>48</sup> Notice of Proposed Rule 132 and Proposed Amendments to Rule 405 and to Form S-1, S-7, S-8, S-9 and S-14 under the Securities Act of 1933 and Notice of Proposed Rule 3b-6 and Proposed Amendments to Rules 12b-2, 13a-11, 14a-9 and 15d-11; to Rules 14a-3 and 14c-3 Relating to Annual Reports to Security Holders; and to Forms 8-K and 10-K, Under the Securities Exchange Act of 1934 to Implement the "Statement by the Commission on the Disclosure of Projections of Future Economic Performance" and to Provide for a More Timely Filing of the Change of Control Item of Form 8-K. Exchange Act Release No. 34-11374, 1975 WL 15455 (S.E.C.) (April 28, 1975).

must be prepared with care, have a reasonable basis and must be complete. Once disclosed, issuers are subject to a continuing duty to update the information as circumstances change. Had the proposal been approved, the practical effect would have been to reduce greatly the number of projections provided to the Commission, or to anyone else, since the proposal would have had the real-world effect of sharply increasing the cost to issuers of providing any projection to a third party. Somewhat lamely, the Commission insisted that it "does not believe that projections are per se misleading or fraudulent."<sup>49</sup>

True to its word, the Commission's proposal did not require issuers to provide projections. Instead, the Commission proposed to amend Form 8-K to require that a registrant under the Exchange Act file a projection with the Commission within ten days of furnishing "a projection to any person, except a government agency."<sup>50</sup> A "projection" was defined as "a statement made by an issuer regarding material future revenues, sales, net income or earnings per share of such issuer, expressed as a specific amount, range of amounts or percentage variation from a specific amount, or a confirmation by an issuer of any such statement made by another person."<sup>51</sup>

The information required was extensive:

(1) A statement of the projection including the time period covered by the projection. (2) A statement which (i) discloses the material assumptions underlying the projection; (ii) cautions that there can be no assurance that the projection will be achieved since its ultimate achievement is dependent upon the occurrence of the specified assumptions; and (iii) indicates whether the projection has been compiled on the basis of the specified assumptions and whether it is consistent with the accounting principles expected to be used by the registrant. (3) A statement of the circumstances in which the projec-

---

<sup>49</sup> *Id.* at 5.

<sup>50</sup> Proposed Form 8-K, Item A, (a), *id.* at 19. As to government agencies, Proposed Form 8-K, Item A, (c), provided:

If the registrant has furnished a projection to any government agency, foreign or domestic, other than the Commission, give the name and location of such agency and describe the circumstances under which the projection was furnished. If the projections furnished to such agency are materially different from any projection filed with the Commission, briefly describe such differences.

*Id.* at 20.

<sup>51</sup> Proposed Rule 12b-2—Definition of "Projection," *id.* at 16, Proposed Amendment to Rule 405—Definition of "Projection." *Id.* at 23-24.

tion was furnished including the date it was furnished and the manner in which it was communicated. (4) If the registrant has represented to any person, other than in connection with a transaction or to a person described in Instruction 1, that a projection furnished in response to this item has been reviewed by any person other than an officer, director or employee of the registrant, give such person's name and address, and file such person's report, if any, as an exhibit to this report.<sup>62</sup>

That was just the beginning. Once a registrant had filed a projection, it then had a continuing duty to file another Form 8-K if it came "to believe that any projection previously filed or required to be filed with the Commission no longer has a reasonable basis."<sup>63</sup> Moreover, when it came time to file its annual form 10-K, registrants were required to "[f]urnish all projections filed or required to be filed with the Commission covering the year-end results for the fiscal year covered by this report [and include] a statement of the material assumptions underlying each projection, if not previously filed."<sup>64</sup> If any projections were revised, registrants were also required to "briefly describe the reasons for each material revision."<sup>65</sup>

That was not all. The instructions went on:

The most recent projections for the fiscal year covered by this report should be presented in comparative form with the corresponding historical results. Where a projection differs from the corresponding historical result by a factor of 10 percent or more, set forth the material reasons for such difference. If the projection was expressed as a range, the percentage difference shall be measured from the endpoints of such range.<sup>66</sup>

Finally, the proposed form provided:

---

<sup>62</sup> Proposed Form 8-K, Item A. (a), *Id.* at 19. The proposal also required exhibits: "1. Copies of any published statements containing the information furnished in answer to Item A of Part I together with any related material submitted in connection with the particular publication[; and] 2. Copies of any report furnished pursuant to Item A(a)(4) of Part I." Proposed Form 8-K, Exhibits, *Id.* at 21.

<sup>63</sup> Proposed Form 8-K, Item A(b) "Revision of Projection," *id.* at 19. The registrant would be required to file a revised projection. If the registrant could not provide a revised projection, it had to set forth an "explanation of the reasons for its inability to furnish the revision together with a brief description of material changes, if any, in the material assumptions underlying such projection." *Id.* at 14.

<sup>64</sup> Proposed amendment to Form 10-K, Item 2A. Projections, (a), *Id.* at 22. It would have been a violation of 8-K not to have previously filed a statement of the material assumptions.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

(b) If the registrant made projections for the last fiscal year, the current year or any future period that were filed or required to be filed with the Commission, and has not determined to cease disclosing projections, the registrant shall furnish projections for at least the first six months of the current fiscal year or for the full fiscal year, whether or not previously filed. Include at a minimum projections of sales or revenues, net income and fully diluted earnings per share. Also include a statement which (i) discloses the material assumptions underlying the projections; (ii) cautions that there can be no assurance that the projections will be achieved since their ultimate achievement is dependent upon the occurrence of the specified assumptions; and (iii) indicates whether the projections have been compiled on the basis of the specified assumptions and whether they are consistent with the accounting principles expected to be used by the registrant. If the registrant has determined to cease disclosing projections, set forth the reasons for such determination.<sup>57</sup>

The proposal was softened somewhat by providing some exemptions from the requirement that projections made to "any person" must be filed. Exceptions were provided for private placements of securities, commercial loan transactions, negotiations with underwriters, preliminary negotiations regarding a proposed business combination, disclosure to government agencies "which has afforded the related projections non-public treatment," and the registrant's accountants or counsel.<sup>58</sup> Then, lest these exemptions prove too broad, they were all qualified by a provision that the exceptions would not apply where the projection was "made as part of a plan or scheme to evade the requirements of this paragraph."<sup>59</sup> Thus, projections made to a potential executive, to a business consultant, or to a major customer, for example, were not exempted. The exception closed with a cautionary "NOTE: Registrants should caution persons who receive non-public projections about the anti-fraud provisions of the federal securities laws, particularly Rule 10b-5 under the Act."<sup>60</sup> The implicit message, of course, is that persons in receipt of projections that were not filed with the Commission could be considered in possession of material inside information and subject to the insider trading rules.

---

<sup>57</sup> Proposed amendment to Form 10-K, Item 2A. Projections, (b), *id.*

<sup>58</sup> Proposed Form 8-K, Item A., Instruction 1, *id.* at 20.

<sup>59</sup> Note to Instruction 1, Proposed Form 8-K, *id.* at 20.

<sup>60</sup> *Id.*

The proposal meant that each registrant would be required to have an internal system for determining when an employee of the registrant had made a projection to a person not exempted, for having that projection reported to the employee responsible for SEC filings and getting it filed within ten days, for thereafter keeping track of all the projections that had been made, and for each year compiling and comparing the projections. Once a projection had been made, the registrant would then be required when filing their 10-K each year to prepare new projections for the first six months of the next fiscal year, which would then require that it do the same the following fiscal year, and so on.<sup>61</sup>

The proposal also contained a safe harbor to protect the registrant from liability for having made the required projections. It provided that a projection would not be deemed to be in violation of the Exchange Act even if the projected result

---

<sup>61</sup> The Commission gave the following illustration:

Example I - Mandatory Filing Requirements

A. Facts

Y Company is subject to the reporting requirements of Section 13 of the Exchange Act. In response to an analyst's telephone inquiry on April 15, 1975, the financial vice-president of the company states that Y Company expects to have earnings of \$6.00 per share for the year ended December 31, 1975.

B. Filing Requirements

1. This statement triggers the filing requirements of Item A of Part I of Form 8-K. Accordingly, Y Company must file a report on Form 8-K within ten days (before April 25, 1975) containing a statement of the projection, the material assumptions underlying the projection, and the circumstances in which the projection was disclosed.

2. Y Company has now entered the disclosure system for projections and has these obligations:

(a) It must file a report on Form 8-K when it has reason to believe that the projection no longer has a reasonable basis.

(b) It must include the projection in its 1975 annual report on Form 10-K, and compare it with actual results for the year.

(c) It must also include projections for the first six months of 1976 or for the entire year in its 1975 annual report on Form 10-K unless the company chooses to exit from the disclosure system for projections.

(d) It must include the projection in any registration statement on Forms S-1, S-7, S-8, S-9 or S-14 filed during 1975 or 1976; provided that if such registration statement is filed during 1976, the projection must be compared with actual results for 1975.

(e) It must include the projection information required by Form 10-K in its annual report to shareholders if the company is subject to the proxy rules.

was not achieved, if certain exacting requirements were met. The requirements included that the registrant have been an Exchange Act registrant for three years; that the registrant had "prepared budgets for internal use for its last three fiscal years," that the projections had "been prepared with reasonable care by qualified personnel and carefully reviewed and approved by management at the appropriate levels"; that the projections have "a reasonable factual basis and represent[ ] management's good faith judgment"; that the projections "relate[ ] at a minimum to sales or revenues, net income and fully diluted earnings per share"; and that it be "expressed [in] exact figures, a reasonable variation from an exact figure, or a reasonable range of figures."<sup>62</sup> Finally, the proposal provided a mechanism by which a registrant could exit from what the Commission called the "disclosure system for projections."<sup>63</sup> Registrants could file notice that they had determined to cease disclosing or revising projections, but had to describe "the reasons for such determination."<sup>64</sup>

Uncharacteristically, both issuers and analysts vigorously opposed the proposal.<sup>65</sup> Typically, issuers oppose extensions of the reporting requirements because they are the ones who bear the costs, while analysts welcome them because they are the ones who can use the information (and do not have to pay for it). In this case, the analysts saw that the effect of the proposal would be to cut them off from projections,<sup>66</sup> that they would get less, not more, information. Analysts, therefore, closed ranks with the issuers. Their reaction made it clear beyond dispute that Kripke was right: analysts did have access to management projections and they were not going to give them

---

<sup>62</sup> Proposed Rule 3b-6(a)(2), *id.* at 17. There were additional requirements if the registrant had represented to any person that a projection had been reviewed by any outsider. Proposed Form 8-K, Item A, (a)4, *id.* at 19.

<sup>63</sup> *Id.* at 9.

<sup>64</sup> Proposed Form 8-K, Item A(d) "Determination to Cease Disclosing or Revising Projections," *id.* at 20.

<sup>65</sup> The arguments against the proposal made by commentators are summarized in ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, *supra* note 1, Appendix A, at A-291 to A-293. There apparently was an Appendix B to the Report summarizing the comments, but I have not seen a copy.

<sup>66</sup> "[V]irtually all of the commentators opposed the proposals because they felt such proposals would be counterproductive, leading to a 'blackout' of projection communications between management and the investment community." ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, *supra* note 1, at A-291.



up without a fight.

The next spring the Commission retreated. It first announced the formation of an "Advisory Commission on Corporate Disclosure." The news was presented as if the Commission was above the fray, simply trying to keep up with the state of the art through objective examination of available data. The implication was that the formation of the Committee had nothing to do with any particular issue before the Commission:

Substantial questions concerning the substance and effectiveness of the corporate disclosure system continue to be raised. In some measure, these questions reflect the intensification of forces identified by Commissioner Wheat, such as the increasing institutionalization of the markets. Moreover, since the time of that Report, an increasing body of scholarly work examining the economics and structure of information systems has evolved; increasing consideration has been given to the "random-walk theory" and the efficient-market hypothesis; new techniques of portfolio management are being utilized and penetrating questions have been asked concerning the costs and benefits of the current system. In addition, the President and Congressional leaders have urged all units of government to examine their practices and procedures to determine whether they are cost effective, whether they impose inordinate burdens on business and the public, and whether competitive forces, among other factors, might be substituted for governmental regulation.<sup>67</sup>

Homer Kripke, a member of the Advisory Committee appointed by the Commission to undertake the study, reports that he took this seriously.<sup>68</sup> He thought the Committee was going to undertake the kind of serious investigation he had been urging of the way investors actually make investment decisions. Martin Lipton, another member of the Committee and a prominent practicing attorney, led the Committee back to the "real world."<sup>69</sup> Although the Committee reported the

---

<sup>67</sup> Announcement of Appointment of Advisory Committee on Corporate Disclosure, Release No. 33-5673, 34-12064, 1976 WL 15973, February 2, 1976, at 1.

<sup>68</sup> "Because I took for granted that a fundamental weighing of the usefulness and performance of the mandatory disclosure system would eventually be undertaken, pursuant to the Committee's charge, I set aside a book on the SEC and disclosure that I had been working on for some time." KRIPKE, *supra* note 6, at 303. Kripke details how he was isolated by the Committee in his dissent to the report. ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, *supra* note 1, at D-49 to D-56. His isolation was inevitable, given that Kripke never had a program except more research.

<sup>69</sup> "I was the first person on the Disclosure Advisory Committee who, after a half hour of random talk of efficient market or whatever, would say, 'Let's get

results of surveys of issuers, analysts, investment decisionmakers, information disseminators, registered representatives and individual investors, its recommendations were pragmatic recommendations directed to specific issues confronting the Commission and bearing no relationship to the information it collected.<sup>70</sup>

Three months after the formation of the Committee, the Commission abandoned its proposal for a "disclosure system for projections."<sup>71</sup> Announcing that it would no longer hamper the inclusion of projections in filings, the Commission emphasized that it was "neither encouraging or [sic] discouraging the making and filing of projections because of the diversity of views on the importance and reliability of projections."<sup>72</sup> Furthermore, the Commission innocently added: "This issue, along with the question of the need for a safe-harbor rule for projections, may be among those appropriately considered by the Advisory Committee on Corporate Disclosure."<sup>73</sup>

The Committee recommended that the Commission encourage but not require projections, and that it should provide a safe harbor for projections unless the projections were either prepared without a reasonable basis or disclosed in other than good faith.<sup>74</sup> The Commission did so for projections in documents filed with the Commission.<sup>75</sup> Since the safe harbor did

back to the real world." Remarks of Martin Lipton in *Books for the Bar: Discussion of the SEC and Corporate Disclosure: Regulation in Search of a Purpose*, 56 N.Y.U. L. REV. 1285, 1295-96 (1981) (reviewing KRIPKE, *supra* note 6).

<sup>70</sup> As Kripke pointed out, "I do note, however, how little the Committee's conclusions rest on the field study. Indeed, examination of the Committee's minutes will show that all of the Committee's important conclusions except the Introduction were reached before the results of the field study were available." ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, *supra* note 1, at D-54.

<sup>71</sup> Notice of Adoption of An Amendment of Rule 14a-9 Under the Securities Exchange Act of 1934 and Withdrawal of the Other Proposals Contained in Release No. 33-5581 . . . , Securities Act Release No. 33-5699, 1976 WL 16007 (S.E.C.) (April 23, 1976). See also SECURITIES AND EXCHANGE COMMISSION, ANNUAL REPORT [FISCAL YEAR] 1976 at 27-28 (undated, prob. 1977).

<sup>72</sup> SECURITIES AND EXCHANGE COMMISSION, ANNUAL REPORT, *supra* note 71, at 2.

<sup>73</sup> SECURITIES AND EXCHANGE COMMISSION, ANNUAL REPORT, *supra* note 71, at 2.

<sup>74</sup> ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, *supra* note 1, at 364.

<sup>75</sup> Rule 175, 17 C.F.R. § 230.175 (1995), and Rule 3b-6, 17 C.F.R. § 240.3b-6 (1995) (originally promulgated in Safe Harbor Rule for Projections, Securities Act Release No. 33-6084, 1979 WL 16388 (S.E.C.) (June 25, 1979)). The Commission limited the safe harbor to projections in filing with the Commission, while the

not protect projections from being deemed fraudulent if made without a reasonable basis or made other than in good faith, however, it provided little more protection for projections than did the *Ernst & Ernst v. Hochfelder* standard of scienter adopted by the Supreme Court for 10b-5 actions four years earlier in 1975.<sup>76</sup>

In 1994, still faced with the reluctance of issuers to make projections, the Commission returned to the issue, scheduling hearings for early 1995 on the subject.<sup>77</sup> The theme of the release announcing the hearings was the possibility that fear of liability under the securities laws discourages the release of projections.<sup>78</sup>

## B. Segmentation

The issue of segmentation is much more difficult than the issue of projections. It was thrust onto the Commission's disclosure agenda prior to the projections issue. Like the projections issue, it remains an unresolved problem today.<sup>79</sup>

Segmentation was forced onto the Commission's agenda as a byproduct of antitrust concern about conglomerate mergers.

---

Advisory committee had recommended a safe harbor for all projections, whether or not made in a filing with the Commission.

<sup>76</sup> 425 U.S. 185 (1975). For a discussion of the *Hochfelder* standard, see note 14 *supra*.

<sup>77</sup> Safe Harbor For Forward-Looking Statements: Concept Release, Securities Act Release 7101, 1994 WL 562021 (S.E.C.) (Oct. 13, 1994) [hereinafter "1994 Concept Release"]. Section 205 of H.R. 10, 104th Cong. 1st Sess., requires the Securities and Exchange Commission to adopt a new safe harbor for predictive statements meeting specified statutory criteria. Section 206 provides for a stay of discovery pending a ruling on a summary judgment motion to dismiss a case on the ground that a forward-looking statement was protected by the safe harbor. H.R. 10, introduced January 4, 1995, titled A Bill to Reform the Federal Civil Justice System; to Reform Product Liability Law, is part of the legislative package popularly known as "the Contract with America."

<sup>78</sup>

Some have suggested that companies that make voluntary disclosure of forward-looking information subject themselves to a significantly increased risk of securities anti-fraud class actions. Recent surveys suggest that this threat of mass shareholder litigation, whether real or perceived, has had a chilling effect on disclosure of forward-looking information.

1994 Concept Release, *supra* note 77, at 8.

<sup>79</sup> The Financial Accounting Standards Board released PAUL PACTER, RESEARCH REPORT: REPORTING DISAGGREGATED INFORMATION (1993), designed as a background paper for consideration of further initiatives in this area.

The industrial-organization economists complained that one consequence of conglomerate mergers was that they blurred the available statistics on particular industries.<sup>80</sup> The then-prominent Senator Philip A. Hart (for whom the Hart Senate Office Building is named) chaired the Judiciary Committee's Subcommittee on Antitrust and Monopoly. He was opposed to increasing industrial concentration achieved through conglomerate mergers, even when those mergers were not in violation of the antitrust laws. An economist who shared this view, Dr. Joel Dirlam, posed the issue as one of investor protection in testimony to the committee. Dr. Dirlam testified:

I would speak also on behalf of the average investor who does not know what he is buying into when he purchases one of these large diversified firms. He has only the overall statement to go by. He judges then not the industry but the behavior of the firm itself, and he stakes his money on the management with a minimum of information. . . . I do think that an amendment to the Securities and Exchange Act could require that corporations disclose on a fuller basis than they do now their sales and operating income from different activities in which they may be engaged. Such knowledge should be available both to the average investor and the antitrust authorities.<sup>81</sup>

The implicit argument is that segmented data provides investors better information for evaluating the accuracy of securities prices than unsegmented information. The argument proceeds from the idea that investors need information rele-

---

<sup>80</sup> Joel Dirlam put it this way:

I might conclude by saying that as a student on the problems of industrial organization, I feel myself faced by technological obsolescence. Automation may destroy my job. As these large firms become more and more diversified, the material which has been made available by this committee and which has been so useful in the past in the shape of concentration ratios, values of shipments, numbers of companies and plants in various four-digit industries and five-digit product class groups becomes of less and less significance, and one has to concentrate more and more upon the individual firms.

*Economic Concentration: Hearings Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 89th Cong., 1st Sess. 745, 770 (1965) (testimony of Dr. Joel Dirlam). The implicit argument that Congress should impose reporting requirements in order to enable academic industrial organization economists to continue to use their methodologies is breathtaking. Of course the economists are not alone. High-energy physicists argue that the government should spend tax revenue in order to build expensive facilities so that they can have new data to analyze.

<sup>81</sup> *Id.* at 769-70.

vant to predicting future cash flows. Issuers are involved in many different activities. If their accounting results are reported on a consolidated basis, the accounting information will combine the revenues and costs of different activities. If, for instance, the issuer has an aerospace subsidiary and a steel subsidiary, the future that each subsidiary faces could be different. When the results are consolidated, it is impossible for outsiders to determine the relative profitability of each segment, the historical trend of profitability in each segment, or to understand how changes in each industry will affect the overall profitability of the issuer. Analysis of a "steel-air" business is analysis of a fictional and nonexistent business whose results are reported only because two quite different businesses have a common owner. Similar problems of interpretation and analysis exist concerning results combined from parts of the business operating in different geographic areas. A steel business in Brazil may have very different prospects than a steel business in Europe.<sup>82</sup>

Since more information is always better than less, if the objective is to make predictions that are as accurate as possible, there is no clear stopping place as to the amount of detail that should be reported. Even a steel business located in a single geographic area may, in fact, be many different businesses—say the production of construction steel for the building industry, the production and fabrication of steel parts for the automobile industry, the production of specialty steel for the aerospace industry, and so on. So too, an analyst would like to know the identity of important customers, the amount of their business and the extent they contribute to profitability. After all, profits earned from an important but financially marginal customer are much less likely to continue than profits from a thriving and growing one. Because there is no obvious stopping point, the debates about segmentation have not reached equilibrium. No matter how much segmentation there is, it can always be argued that accuracy enhancement re-

---

<sup>82</sup> Daniel W. Collins, *SEC Product-Line Reporting and Market Efficiency*, 2 J. OF FIN. ECON. 125 (1975). Collins uses segment reporting data for 1968-69 first reported by issuers in response to revised SEC requirements in 1970 to study the impact of segment reporting. He reports, as the argument in the text suggests it would, that segment reporting improves the ability of traders to predict future warnings. See also note 88, *infra*.

quires greater segmentation.<sup>83</sup>

While Senator Hart was never able to get Congress to pass legislation to stop firm growth through conglomeration, he was able to pursue the "conglomerate issue" in other ways. Somehow, Senator Hart enlisted to his cause Manuel Cohen, then the Chairman of the Commission. By the fall of 1966, Cohen was making speeches containing not very subtle threats that if the accounting profession did not do something about segmentation, the Commission would. Cohen said:

I must admit that some of the initial presentations to us do not communicate the sense of urgency which I believe should pervade our discussions. I hope that the same attitude will be applied to your work on conglomerate companies [whose new prominence had raised the importance of the segmentation issue] and other current problems, and that you will continue to fulfill your obligations to the public in such a way that we will not be required to consider the need for us to fill a gap.<sup>84</sup>

Almost three years later the Commission acted.<sup>85</sup> It

---

<sup>83</sup> One stopping point is the meaningfulness of the segmentation. At some point the revenues are attributable to so many jointly incurred costs that the notion of segmentation loses its meaning. Not even management could tell exactly which is the profitable product line, the profitable customer, or the profitable geographic area. But if the point is to require the disclosure of the best available information, then why not require the disclosure of highly segmented information and let the users of the information determine what it is worth?

Another stopping point is the cost of segmenting the information into finer and finer categories. But management needs to know which activities are profitable and which are not, in order to plan investment decisions. Managements should not want to expand unprofitable activities, and they should want to expand profitable activities. So to make good investment decisions, management needs to develop methods of analysis that enable it to separate profitable from unprofitable activities. Once management develops that analysis, the further costs of sharing it with investors are minor.

<sup>84</sup> Manuel F. Cohen, *The SEC and Accountants: Co-operative Efforts to Improve Financial Reporting*, J. OF ACCT., Dec. 1966, at 56, 59-60. These events as of the end of 1966 are reviewed in A.A. Sommer Jr., *Conglomerate Disclosure: Friend or Foe*, 22 BUS. LAW. 317 (1967) and Seligman, *supra* note 4, at 432-36. In another speech, Chairman Cohen favorably cited the British (as well as other foreign) practice, just as his successor, Casey, was to do later in connection with projections. See *supra* text at accompanying notes 43-46. Manuel Cohen, *Analysts, Accountants and the SEC—Necessary Joint Efforts*, J. OF ACCT. Aug. 1966, at 57, 60-61.

<sup>85</sup> Adoption of Amendments to Forms S-1, S-7 and 10, Securities Act Release No. 33-4988, 1969 WL 8926 (S.E.C.) (July 14, 1969) [hereinafter "Release 4988"]. The Commission had proposed the amendments in Securities Act Release 4922 (Sept. 4, 1968) and Notice of Revision of Proposed Amendments to Forms S-1, S-7 and 10, Securities Act Release No. 33-4949, 1969 WL 8894 (S.E.C.) (Feb. 18, 1969).

amended the registration forms to require that:

Where a registrant and its subsidiaries are engaged in more than one line of business, the amendments require the disclosure for each of a maximum of the last five fiscal years subsequent to December 31, 1966, of the approximate amount or percentage of total sales and operating revenues and of contribution to income before income taxes and extraordinary items attributable to each line of business which contributed, during either of the last two fiscal years, a certain proportion [which for companies with sales in excess of \$50 million was to be 10 percent] to (1) the total of sales and revenues, or (2) income before income taxes and extraordinary items.<sup>85</sup>

The only important change from previous Commission requirements was that the threshold proportion was reduced from fifteen to ten percent. The Commission refused to impose any requirements as to how a line of business was to be defined or how revenues and overhead costs were to be allocated to any one line of business.<sup>87</sup> The resulting information was of no use

---

[hereinafter "Release 4949"]. In the meantime the Accounting Principles Board (predecessor to the FASB had issued Statement No. 2, Disclosure of Supplemental Financial Information by Diversified Companies (September 1967). "For the present, the Board urges diversified companies to review their own circumstances carefully and objectively with a view toward disclosing voluntarily supplemental financial information as to industry segments of the business." The WHEAT REPORT, which was issued between the date of the proposals cited above and their adoption, stated that "the conferences held by the Study strongly substantiated the need for this additional information in the prospectus." The WHEAT REPORT, *supra* note 33, at 89. The Study recommended that the segmentation requirement be extended to annual reports on Form 10-K. The WHEAT REPORT, *supra* note 33, at 89. See also The WHEAT REPORT, *supra* note 33, at 338. This was done in 1970. Adoption of Revised Form 10-K, Exchange Act Release No. 34-9000 at 5, 1970 WL 9841 (S.E.C.) (Oct. 21, 1970).

<sup>85</sup> Release No. 4988, *supra* note 85, at 1-2.

<sup>87</sup> The Commission explained its refusal as follows:

Various suggestions were made for more specific indications of the meaning of "line of business." However, in view of the numerous ways in which companies are organized to do business, the variety of products and services, the history of predecessor and acquired companies, and the diversity of operating characteristics, such as markets, raw materials, manufacturing processes and competitive conditions, it is not deemed feasible or desirable to be more specific in defining a line of business. Management, because of its familiarity with company structure, is in the most informed position to separate the company into components on a reasonable basis for reporting purposes. Accordingly, discretion is left to the management to devise a reporting pattern appropriate to the particular company's operations and responsive to its organizational concepts.

Adoption of Amendments to Forms S-1, S-7 and 10, Release No. 4988, *supra* note 86, at 1.

to the industrial-organization economists, both because there would be no comparability in the data between firms, no correspondence between the SEC disclosure data and the standard industrial classifications, and only fragmentary information on changes over time.<sup>88</sup> At that point, industrial-organization economists gave up on the SEC as a vehicle for collecting the information they wanted.

The subsequent history of the segmentation issue divides into two distinct branches: one the history of a data-collection program conducted by the Federal Trade Commission ("FTC"), the other the continuing evolution of financial reporting. The industrial-organization economists were able to enlist the assistance of the FTC in 1970 to collect lines of business data.

### 1. The FTC Line-of-Business Program

The FTC's experience with its line-of-business program, as it came to be called, is instructive because it turned out to be a failure. In the end, the FTC collected only four years of complete data,<sup>89</sup> in spite of the fact that the FTC was the perfect

---

<sup>88</sup> Collins, *supra* note 82, at 125-64. Collins studied whether additional information was made available as a result of the SEC's segmentation requirements in spite of these limitations. Collins exploited the fact that firms implemented the SEC requirements at different times. Surprisingly (given the bluntness of the SEC's segmentation requirement), Collins found that the SEC segmentation data improved the ability of a simple predictive model to predict security prices. The results were not statistically significant. See Collins, *supra* note 82, at 138-39, 146-47. His data set, derived from the short transition period, generated a small number of observations. Others have also attempted to exploit this event to study the relationship between increased information disclosure and market price behavior. See generally, Siva Swaminathan, *The Impact of SEC Mandated Segment Data on Price Variability and Divergence of Beliefs*, 66 ACCT. REV. 23-41 (Jan. 1991), and articles cited therein.

<sup>89</sup> Years and date of publication of aggregate reports: 1973 (incomplete data sample), March 1979; 1974, September 1981; 1975, September 1981; 1976, May 1982; 1977, April 1985. David J. Ravenscraft & Curtis L. Wagner III, *The Role of the FTC's Line of Business Data in Testing and Expanding the Theory of the Firm*, 34 J. OF L. & ECON. 703, 731 (1991). Failure is my evaluation. The data set produced does not cover a long enough period to enable it to be used to illuminate important economic cause-and-effect relations, which unfold over periods longer than four years. Ravenscraft and Wagner suggest that cross-sectional analysis can be used to solve this problem. *Id.* at 716. Their article collects the basic materials for judging the success or failure of the program. See particularly the comprehensive bibliography of publications and papers using data from the program. *Id.* at 732-39. The program had the problems of defining industries and allocating joint



agency to conduct the program.<sup>90</sup> First, a statutory purpose of the FTC is to study the economy.<sup>91</sup> Second, the FTC has broad statutory authority to require the production of information relevant to the economy. Third, unlike the SEC, the FTC's power to compel the production of economic information is not tied to making the information public. Rather, it could collect information for its own study purposes without making some or all of it public, thus overcoming concerns based on claims of confidentiality.<sup>92</sup>

The FTC first proposed that it collect information organized on a line-of-business basis<sup>93</sup> in 1971. It was required to submit the forms which were to be used to collect the information to the Office of Management and Budget ("OMB") under the Federal Reports Act.<sup>94</sup> The Nixon OMB refused to approve the forms. In 1973 OMB's power was curtailed when the authority to approve forms of the independent regulatory agen-

---

costs that the SEC refused to confront. The choices (and compromises) involved in the design of such a program are discussed by Frederic M. Scherer, *Segmental Financial Reporting: Needs and Trade-Offs*, in BUSINESS DISCLOSURE: GOVERNMENT'S NEED TO KNOW 3 (Harvey J. Goldschmid ed., 1979).

<sup>90</sup> I remember a discussion with Professor Frederick Scherer, just before he went to the FTC as its Chief Economist, that the exciting thing about working for the FTC would be the opportunity to participate in path-breaking research using unique data never before available. His expectation that the line of business data would be produced in due course was a reasonable one given the powers of the Commission and its support for the line-of-business program. In fact, the FTC was unable to collect any data before he had resigned. Frederick Scherer was Chief Economist of the FTC from 1974 to 1976. WHO'S WHO IN AMERICA 1994.

<sup>91</sup> The history of the FTC's broad mandate to study the economy, along with a retrospective overview of the corporate patterns survey and the line-of-business program, is described in Frederick M. Scherer, *Sunlight and Sunset at the Federal Trade Commission*, 42 ADMIN. L. REV. 461 (1990).

<sup>92</sup> As long as the information could be characterized as a trade secret under the Freedom of Information Act, 15 U.S.C. § 552(b)(4)(1988).

<sup>93</sup> This meant, in this context, in categories aligned with the standard industrial classification system.

<sup>94</sup> Federal Reports Act of 1942, ch. 811, 44 U.S.C. §§ 3501-3511 (1988). The purposes were

- (1) to minimize the federal paperwork burden for individuals, small businesses, State and local governments, and other persons;
- (2) to minimize the cost to the Federal Government of collecting, maintaining, using, and disseminating information;
- (3) to maximize the usefulness of information collected, maintained, and disseminated by the Federal Government; [and]
- (4) to coordinate, integrate and, to the extent practicable and appropriate, make uniform Federal information policies and practices.

44 U.S.C. § 3501 (1988).

cies was transferred to the General Accounting Office.<sup>95</sup> The General Accounting Office proved more accommodating,<sup>96</sup> and the FTC's program was launched.

Firms required to produce the information struck back. In Congress they successfully lobbied to obtain amendments to the FTC appropriations acts that restricted the availability of the data.<sup>97</sup> In the courts they filed massive litigation<sup>98</sup> which

<sup>95</sup> Trans-Alaska Pipeline Authorization Act § 409(b), Pub. L. No. 93-153, 87 Stat. 576 (1973), reprinted in 1973 U.S.C.C.A.N. 639, 658-59. The President supported the bill so that the oil industry could proceed to build the Trans-Alaskan Pipeline in the face of environmental challenges. The amendment of the Federal Reports Act was attached, along with a number of other miscellaneous items, in the Senate, and accepted by the Conference Committee. See H.R. Rep. No. 624, 93rd Cong., 1st Sess. (1973), reprinted in 1973 U.S.C.C.A.N. 2523, 2525.

<sup>96</sup> George J. Benston, *The FTC's Line of Business Program: A Benefit-Cost Analysis*, in BUSINESS DISCLOSURE: GOVERNMENT'S NEED TO KNOW 58, 58-59 (Harvey J. Goldschmid ed., 1979), reports that the General Accounting Office concluded that the "data 'would be unreliable at best and may be seriously misleading,'" and that the FTC had underestimated company compliance costs, but approved the program on the ground that these considerations were not within its authority (citing PHILLIP S. HUGHES (ASSISTANT COMPTROLLER GENERAL), REPORT TO THE COMPTROLLER GENERAL OF THE UNITED STATES IN THE EVALUATION OF THE FEDERAL TRADE COMMISSION'S PROPOSED ANNUAL LINE OF BUSINESS REPORT (FORM LB) 15 (1974)).

<sup>97</sup> These year-to-year restrictions were finally codified in the Federal Trade Commission Improvements Act of 1980 § 4, 15 U.S.C. § 46 (1994). The restrictions as codified provide that:

No officer or employee of the Commission or any Commissioner may publish or disclose information to the public, or to any Federal agency, whereby any line-of-business data furnished by a particular establishment or individual can be identified. No one other than designated sworn officers and employees of the Commission may examine the line-of-business reports from individual firms, and information provided in the line-of-business program administered by the Commission shall be used only for statistical purposes. Information for carrying out specific law enforcement responsibilities of the Commission shall be obtained under practices and procedures in effect on the date of the enactment of the Federal Trade Commission Improvements Act of 1980, or as changed by law.

*Id.* A Senate Report by the Commerce, Science, and Transportation Committee explained: "The section has specific protections to prevent harm to companies that supply the data." S. REP. NO. 500, 96th Cong. 1st Sess. 12 (1979), reprinted in 1980 U.S.C.C.A.N. 1102, 1114. Ravenscraft and Wagner report that the FTC has been able to mitigate the impact of this restriction to some extent by making interested researchers "uncompensated special consultants to the FTC's Bureau of Economics. Data processing must be conducted at the FTC, using the FTC computer facilities." Ravenscraft & Wagner III, *supra* note 89, at 709. This practice was challenged unsuccessfully in *Aluminum Co. of America v. FTC*, 589 F. Supp. 169 (S.D.N.Y. 1984).

<sup>98</sup> Perhaps a better term is crowded. The main action was *In re* FTC Corporate

managed, in spite of its specious basis,<sup>99</sup> to put the program under a cloud until 1978 and helped delay completion of the data collection.<sup>100</sup> In 1984 the Reagan FTC,<sup>101</sup> with the 1977

---

Patterns Report Litigations, 432 F. Supp. 274 (D.D.C. 1977), 432 F. Supp. 291 (D.D.C. 1977); *aff'd sub nom.*, Appeal of FTC Line of Business Report Litigation, 595 F.2d 685 (D.C. Cir. 1978), *mandate denied*, *In re* FTC Line of Business Report Litig., 647 F.2d 1124 (D.C. Cir.), *cert. denied*, 439 U.S. 958 (1978). Twelve companies also filed a class action in New York seeking to enjoin the program. Their motion for a preliminary injunction was denied. Aluminum Co. v. FTC, 390 F. Supp. 301 (S.D.N.Y. 1975). The list of counsel in the D.C. Circuit decision shows more than 30 law firms. There were two programs, the line-of-business program, which is the subject of the discussion in the text, and the corporate patterns survey. The latter program was designed to minimize the burden on the reporting firms by requesting data already reported to the census bureau.

Scherer, *supra* note 91, at 479, reports that "guerilla attacks" continued after the main litigation was resolved.

<sup>99</sup> As evidenced by the fact that the FTC's motion for a summary judgment was granted. Here was the best argument, directed to the corporate patterns survey, as summarized in the opinion of the D.C. Circuit:

We next consider whether the Corporate Patterns Report Program impermissibly affronts the Census Act. Specifically, appellants contend that the CPR survey violates the confidentiality provision of the Census Act, which safeguards company-retained copies of census reports from compelled disclosure to any government agency. Appellants insist that this provision protects not only the actual file copy of the census report, but also the company's statistical data that has been prepared in an assertedly "unique fashion" for the purpose of reporting to the Census Bureau. The corporations argue that the Census Act's protection of retained census report copies insulates companies from any future requirement to respond to questions similar to those which the company has already answered in reports to the Census Bureau. Since the CPR survey includes a question essentially identical to an item on the Census Bureau's 1972 Annual Survey of Manufactures, appellants contend that the FTC is demanding information which the Census Act protects from compelled disclosure.

Appeal of FTC Line of Business Report Litigation, 595 F.2d 685, 697 (D.C. Cir. 1978) (footnotes omitted).

<sup>100</sup> *Id.* at 690 n.1 (record references omitted):

Pursuant to the final order and judgment of the District Court entered July 15, 1977, the corporate parties were required to file their Line of Business reports within 150 days of the date of the order and the Corporate Patterns Reports within 90 days. A motion for stay of the enforcement order pending appeal was denied by the District Court on July 22, 1977 and by this court on October 21, 1977. Petition was made to the Supreme Court for a stay pending appeal in this court of the Corporate Patterns Report orders. Justice Brennan granted the petition on November 11, 1977. Following several extensions of the compliance date in the Line of Business program, we issued an order on April 26, 1978 staying enforcement of the LB orders pending our further consideration of the matter.

<sup>101</sup> Scherer, *supra* note 91, at 480-83, attributes the demise of the program to

survey not yet completed, dropped the program.<sup>102</sup>

## 2. The Securities and Exchange Commission, Continued

When the Financial Accounting Standards Board succeeded the Accounting Principles Board in 1973, one of the first issues it addressed was segmentation. This resulted in FASB 14, issued in December 1976. FASB 14 adopted the same ten percent criteria as the SEC had, but it differed from the SEC's requirements in many details. For instance, the SEC had addressed customer disclosure as follows:

If a material part of the business of the registrant and its subsidiaries is dependent upon a single customer, or a very few customers, the loss of any one of which would have a materially adverse effect on the registrant, the name of the customer or customers and other material facts with respect to their relationship, if any, to the registrant and the importance of the business to the registrant shall be stated.<sup>103</sup>

FASB 14, on the other hand, provided that "[i]f 10 percent or more of the revenue of an enterprise is derived from sales to any single customer, that fact and the amount of revenue from each such customer shall be disclosed."<sup>104</sup> In subsequent years the Commission conformed its segmentation requirements to those of FASB 14.<sup>105</sup>

the "inauguration of a President pledged to get government off the backs of business." He also reports that Congress returned authority over FTC information gathering to OMB in the Paperwork Reduction Act of 1980, Pub. L. No. 96-511, 94 Stat. 2812 (1980)(codified as amended at 44 U.S.C. §3501 (1995)), before Reagan took office. *Id.* at 479.

<sup>102</sup> Ravenscraft & Wagner III, *supra* note 89, at 706 (citing FEDERAL TRADE COMMISSION, STATISTICAL REPORT: 1977 ANNUAL LINE OF BUSINESS REPORT 1 (1985)). They report that the FTC in 1984 agreed with the GAO finding of 1974 that the benefits of the program did not exceed its cost.

<sup>103</sup> Release 4949, *supra* note 85 at 6.

<sup>104</sup> FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 14, FINANCIAL REPORTING FOR SEGMENTS OF A BUSINESS ENTERPRISE ¶ 39 (1976) [hereinafter "FASB 14"].

<sup>105</sup> For instance Item 101(b) of Regulation S-K, 17 C.F.R. § 229.101(b)(1995), provides that:

To the extent that financial information included pursuant to this paragraph (b) complies with generally accepted accounting principles, the registrant may include in its financial statements a cross reference to this data in lieu of presenting duplicative information about its segments in the financial statements; conversely, a registrant may cross reference

The Advisory Committee on Corporate Disclosure approved of these developments.<sup>106</sup> It urged the Commission to expand and extend its requirements for segmentation by management, and include a requirement for segmentation in both the annual and quarterly disclosure forms.<sup>107</sup> The Advisory Committee was of the opinion that:

Those who perform investment analysis evaluate the different industries, product lines, markets, etc. of an enterprise individually in order to develop an estimate of the future earnings power of the enterprise as a whole. Accordingly, it makes little sense that investment decision-making information—narrative or financial statement—is presented on an enterprise-wide basis.<sup>108</sup>

The Advisory Committee also noted objections to segmented reporting:

[O]pposition to the requirement centered on the competitive costs of such a reporting obligation. It was generally feared that suppliers, employees, customers and foreign governments would use the figures to extract concessions from the company and that competitors would use the information to invade the registrant's profitable markets. Such disclosure would be particularly dangerous for small companies which might have to disclose relatively more information about their operations than their larger competitors since the line in question might not be significant for the larger company. It might also encourage takeovers.<sup>109</sup>

The Committee Report did not explain why these concerns were unimportant, but it treated them as if they were.

In 1993, the Financial Accounting Standards Board published a research report that "is the first step in an FASB

---

to the financial statements.

<sup>106</sup> ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, *supra* note 1, at 380-390.

<sup>107</sup> When the SEC integrated this disclosure form for the Securities Act and the Exchange Act, the narrative segmentation requirement was incorporated in Form 10-K through its reference to Item 101 of S-K. The quarterly forms still do not require segmentation. Indeed, the accountants expressly exempted interim financial statements from the segmentation requirements of FASB 14. FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 18, FINANCIAL REPORTING FOR SEGMENTS OF A BUSINESS ENTERPRISE—INTERIM FINANCIAL STATEMENTS (1977) [hereinafter: "FASB 18"]. The Commission proposed inclusion of segment information in interim reports in Proposals Regarding Industry Segment and Other Interim Financial Reporting Matters, Management's Discussion and Analysis, and Off Balance Sheet Financing Disclosures, Securities Act Release No. 33-6514 (1984), a proposal never adopted.

<sup>108</sup> ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, *supra* note 1, at 388.

<sup>109</sup> ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, *supra* note 1, at 383.

project to reexamine the existing standards for reporting disaggregated information."<sup>110</sup>

### *C. Management's Discussion and Analysis*

At the end of the 1960's a new disclosure strategy began to emerge in the Commission's disclosure guides—documents designed to push issuers in the direction of good disclosure practices. The strategy, as it finally emerged, is to place on management the responsibility for identifying those aspects of an issuer's operations and accounting results which should be important to investors. Rather than struggling with the problem of identifying with meaningful precision the important information for valuing an issuer, the Commission requires the management of each issuer to struggle with the problem. This strategy involves the same basic issues raised by the Commission's efforts to formulate disclosure policies on forecasting and segmentation. The issues, however, have to be faced firm by firm, rather than in the relative sunlight of the Commission's rule-making procedure. The strategy is now implemented in a section of the disclosure regulations called "Management's Discussion and Analysis."

In 1968, Release 33-4936 promulgated guidelines for the preparation of disclosure documents. The Commission cautiously and without explanation advised:

The necessity of disclosing items in addition to those specified in such instructions [relating to the summary of earnings] will depend upon the circumstances. These instructions cannot, of course, cover all situations which may arise nor is it practicable to set forth a statement of policy dealing specifically with all possible situations. The existence of any unusual conditions affecting the propriety of the presentation and the necessity for the inclusion of an additional previous period should be considered [by management in determining whether to provide supplemental information related to earnings].<sup>111</sup>

Six years later, the idea that it is management's responsibility to help investors understand the relevance of financial statements to the future performance of the company was

---

<sup>110</sup> PACTER, *supra* note 79, at iii.

<sup>111</sup> Guides for Preparation and Filing of Registration Statements, Securities Act Release No. 33-4936, 1968 WL 3988 (S.E.C.) (December 9, 1968), at 9.

articulated, and a section called "Management's Discussion and Analysis of the Summary of Earnings" ("MD&A") was created. In 1974, the Commission revised the guidelines relating to the summary of earnings:

To enable investors to understand and evaluate material periodic changes in the various items of the summary of earnings, a separately captioned section (entitled "Management's Discussion and Analysis of the Summary of Earnings") immediately following such summary should include a statement explaining (1) material changes from period to period in the amounts of the items of revenues and expenses, and (2) changes in accounting principles or practices or in the method of their application that have a material effect on net income as reported. The purpose of this statement is to provide investors with management's analysis of the financial data included on the summary through a discussion of the causes of material changes in the items of the summary and of disclosure of the dollar amount of each such change and the effect of each such change on the reported results for the applicable periods. This discussion is necessary to enable investors to compare periodic results of operations and to assess the source and probability of recurrence of earnings (losses). The analysis should include a discussion of material facts, whether favorable or unfavorable, required to be disclosed or disclosed in the prospectus which, in the opinion of management, may make historical operations or earnings as reported in the summary of earnings not indicative of current or future operations or earnings.<sup>112</sup>

In 1980, the Commission substantially reorganized and recodified its disclosure forms as part of the integration reforms.<sup>113</sup> Disclosure requirements for both the Securities Act and the Exchange Act were placed in one common, master form, form S-K. Item 303 of S-K, which became "Management's Discussion and Analysis of Financial Condition and Results of

---

<sup>112</sup> Notice of Adoption of Amendments to Guide 22 of the Guides for Preparation and Filing of Registration Statements under the Securities Act of 1933 and Adoption of Guide 1 of the Guides for Preparation and Filing of Reports and Registration Statements under the Securities Exchange Act of 1934 (Textual Analysis of Summary of Earnings or Operations), Securities Act Release No. 33-5520, 1974 WL 13616 (S.E.C.) (August 14, 1974).

<sup>113</sup> Amendments to Annual Report Form, Related Forms, Rules, Regulations and Guides; Integration of Securities Acts Disclosure Systems, Securities Act Release No. 33-6231, 1980 WL 20863 (S.E.C.) (Sept. 2, 1980). The reforms are called integration reforms because their purpose was to "integrate" the disclosure requirements of the Securities Act (governing a public offering) and the Exchange Act (governing the periodic disclosures required of issuers). These reforms implemented the ideas advanced by Milton H. Cohen in 1966. Cohen, *supra* note 35.

Operations," remains the same today.

The requirements of Item 303 are more extensive and complex than its predecessors. The disclosure requirements focus on three subjects: (1) liquidity, (2) capital resources and (3) results of operations. The instructions provide that: "The purpose of the discussion and analysis shall be to provide to investors and other users information relevant to an assessment of the financial condition and results of operations of the registrant as determined by evaluating the amounts and certainty of cash flows from operations and from outside sources."<sup>114</sup> Item 303 of S-K also introduced the concept of "known trends." As to liquidity, Item 303 requires registrants to "[i]dentify any known trends or any known demands, commitments, events or uncertainties that will result in or are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way."<sup>115</sup> As to capital resources the instruction states: "Describe any known material trends, favorable or unfavorable, in the registrant's capital resources." Finally, as to the results of operations the item provides: "Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."

In 1986, Coopers & Lybrand submitted to the Office of the Chief Accountant of the SEC a proposal to expand the MD&A disclosure, and make it subject to review by the issuer's independent accountant.<sup>116</sup> A similar proposal was endorsed by all of the "Big Seven" accounting firms.<sup>117</sup> In response, the

---

<sup>114</sup> 17 C.F.R. § 229, Item 303, Instruction 2 to ¶ 303(a) (1995).

<sup>115</sup> 17 C.F.R. § 229, Item 303(a)(1)(1995).

<sup>116</sup> "In 1986, Coopers & Lybrand submitted to the Commission's Office of the Chief Accountant a proposal recommending increased MD&A disclosure of business risks and the performance by the independent auditor of specified review procedures with respect to these disclosures." *Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures*, Securities Act Release No. 33-6835, 1989 WL 258977 (S.E.C.) (May 18, 1989), at 2 [hereinafter "Release 6835"].

<sup>117</sup> "[T]he managing partners of seven accounting firms issued a white paper entitled *The Future Relevance, Reliability, and Credibility of Financial Information; Recommendations to the AICPA Board of Directors*, which also called for increased risk disclosure, but contemplated that such disclosure would be separate from MD&A and would be subjected to audit coverage." The seven were: Arthur Andersen & Co.; Arthur Young; Coopers & Lybrand; Deloitte Haskins & Sells;



Commission issued a concept release asking for comment on these proposals. Virtually all of the 196 commentators opposed the proposal of the accounting profession, and the Commission, instead of adopting the proposal, responded with a release discussing the purposes of Item 303 and providing detailed examples of how to comply.<sup>118</sup>

The concept release is notable for some of the language it used to explain Item 303. In an act of historical reconstruction, the Commission claimed that it "ha[d] long recognized the need for a narrative explanation of the financial statements, because a numerical presentation and brief accompanying footnotes alone may be insufficient for an investor to judge the quality of earnings and the likelihood that past performance is indicative of future performance."<sup>119</sup> Turning metaphorical, the Commission explained: "MD&A is intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short- and long-term analysis of the business of the company."<sup>120</sup>

The Commission has not been pleased with issuer compliance with Item 303. In Release 33-6835, issued in May 1989, the Commission reported that the staff had undertaken "a special review of the MD&A disclosures to assess the adequacy of disclosure practices and to identify any common areas of deficiencies."<sup>121</sup> This "MD&A Project" involved a review of filings by 218 companies. The Commission reported the results of the project thus:

Of the 218 registrants reviewed, 206 received letters of comment, many of which related to more than one report. Three different categories of comments were issued: (a) requests for amendment; (b) requests for supplemental information; and (c) requests for compliance in future filings ('futures' comments). Amendments were filed by 72 registrants in response to staff comments.<sup>122</sup>

---

Ernst & Whinney; Peat, Marwick, Mitchell & Co.; and Touche Ross & Co. Release 6835, *supra* note 116, at 2.

<sup>118</sup> Release 6835, *supra* note 116.

<sup>119</sup> Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release No. 33-6711, 1987 WL 112322 (S.E.C.) (April 17, 1987), at 3 [hereinafter "Release 6711"].

<sup>120</sup> Release 6711, *supra* note 119, at 3.

<sup>121</sup> Release 6835, *supra* note 116, at 2.

<sup>122</sup> Release 6835, *supra* note 116, at 3.

The Commission also reported that:

Work on a second phase of the MD&A Project commenced in October 1988. A total of 141 companies in a second set of 12 industries were selected for review, resulting in 139 comment letters being issued in December 1988. To date, amendments by 53 registrants have been filed in response to staff comments.<sup>123</sup>

The Commission treated this high level of deficiency as a problem of lack of understanding by registrants, and proceeded to discuss what disclosure was required and to give examples of adequate disclosure. The Commission concluded that the distinction between forward-looking or prospective information that was required to be disclosed under Item 303 and such information that can (but does not have to) be disclosed was one area of confusion. Speaking as if it were making the point clear, it said:

Both required disclosure regarding the future impact of presently known trends, events or uncertainties and optional forward-looking information may involve some prediction or projection. The distinction between the two rests with the nature of the prediction required. Required disclosure is based on currently known trends, events, and uncertainties that are reasonably expected to have material effects, such as: A reduction in the registrant's product prices; erosion in the registrant's market share; changes in insurance coverage; or the likely non-renewal of a material contract. In contrast, optional forward-looking disclosure involves anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty. . . . A disclosure duty exists where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial condition or results of operation. Registrants preparing their MD&A disclosure should determine and carefully review what trends, demands, commitments, events or uncertainties are known to management.<sup>124</sup>

As it turned out the Commission had had enough of preaching. It was time for a test case, and the object of the test case turned out to be the Caterpillar Corporation. As its instrument the Commission chose to use new powers conferred by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.<sup>125</sup> The case became *In re Caterpillar*

---

<sup>123</sup> Release 6835, *supra* note 116, at 3.

<sup>124</sup> Release 6835, *supra* note 116, at 5.

<sup>125</sup> The Securities Enforcement Remedies and Penny Stock Reform Act of 1990,

Inc.<sup>126</sup> The decision reports a negotiated settlement in which Caterpillar agreed to cease and desist from violating the Exchange Act and to "implement and maintain procedures designed to ensure compliance with Item 303 of Regulation S-K."<sup>127</sup>

In the spring of 1990, the Caterpillar Corporation was involved in developing forecasts for Caterpillar's 1990 earnings.<sup>128</sup> The Commission opinion does not explain the purpose for which these forecasts were being developed, but it does imply that the forecasts were made available to stock analysts.<sup>129</sup> The forecasts were also discussed with Caterpillar's

---

Pub. Law 101-429, 104 Stat. 931 (1990), which greatly increased the power to the Commission to proceed directly against alleged violators of the securities laws rather than having to proceed in court or by requesting the Department of Justice to bring a criminal charge. Prior to the statute, outside the area of insider trading, the Commission's direct enforcement authority was limited to persons subject to the licensing powers of the Commission. The Commission used new Securities and Exchange Act § 21C, 15 U.S.C. § 78u-3 (1994), which conferred power on the Commission to bring a cease and desist proceeding against "any person who is violating, has violated, or is about to violate any provision of this title." The Commission, no doubt, had in mind the following language from the Report of the House Committee on Energy and Commerce: "[C]ease-and-desist authority would also provide the Commission with an alternative remedy against persons who commit isolated infractions and present a lesser threat to investors." H.R. REP. NO. 101-616, 101st Cong., 1st Sess., 28 (1990). The Commission's law-building strategy in *Caterpillar* is reminiscent of its strategy in relation to insider trading, where its first enforcement action was also a direct administrative proceeding. *In re Cady, Roberts & Co.*, 40 SEC 907, 912 (1961). Later the Commission brought civil proceedings in the courts, which were in turn followed by criminal proceedings.

<sup>126</sup> Securities and Exchange Act Release No. 34-30532, 1992 SEC LEXIS 786 (March 31, 1992) [hereinafter: "Release 30532"].

<sup>127</sup> The following account is based on the Commission opinion only. Since the principal purpose of the opinion in *Caterpillar* is to instruct registrants on their Item 303 disclosure duties, the facts as recounted in the opinion are the relevant ones for the analysis here. Readers familiar with the Caterpillar Corporation no doubt consider the Commission's account incomplete.

<sup>128</sup> The opinion never discloses who was preparing the forecasts, why they were being prepared, or whether there were one or more forecasts in existence. Forecasts can, of course, serve many different purposes. They can be an analytic tool designed to identify changes that need to be made in the conduct of the business. They can be a device to test management's understanding of the business. They can be tools to identify potential future threats to the business. They can be a way of convincing stock analysts that the management understands the business. The opinion does at one point refer to "its 1990 forecast," referring to the accounting department. Release 30532, *supra* note 126, at 2. The reason for preparing a forecast affects the methodology, reliability, and relevance of the resulting forecast.

<sup>129</sup> This can be inferred from Caterpillar's press release on June 25, 1990, which

board of directors.<sup>130</sup>

The forecasters had a problem: Caterpillar's operations in Brazil. During 1989 Brazil had experienced hyperinflation, and Caterpillar's operations there had benefitted. Brazilian contractors, eager to convert their rapidly depreciating cruzados into hard goods, had bought a large number of the big yellow machines for which Caterpillar is renowned. Additionally, Caterpillar was benefitted by a favorable exchange rate.<sup>131</sup> As a result, the earnings of Caterpillar's Brazilian subsidiary, Caterpillar Brazil S.A. ["CBSA"], amounted to twenty-three percent of Caterpillar's worldwide 1989 profits of \$497 million, although only five percent of Caterpillar's worldwide revenues.<sup>132</sup>

The forecasters were apparently quite aware that periods of hyperinflation never last very long, and are always followed by a crash. Along with the deflationary crash would come the probability that CBSA's stellar profit performance would come to an end. The chances that things would change in Brazil had been increased by the fact that a new President, Fernando Collor de Mello, had been elected and a new administration

---

stated that "anticipated results for 1990 would be substantially lower than previously projected." Release 30532, *supra* note 126, at 4. That statement implies that previous projections were known to persons outside the company.

<sup>130</sup> Again, the opinion does not explain why. It is possible that the Board of Directors required management to prepare forecasts to help it evaluate management's performance by comparing actual results against forecasted results.

<sup>131</sup> The Commission's opinion says that "the dollar-cruzado exchange rate lagged behind inflation." Release 30532, *supra* note 126, at 2. My interpretation of this statement is that Caterpillar's Brazilian subsidiary was able to purchase equipment from the parent company at dollar prices and resell the equipment at favorable prices as stated in cruzados. It may also have been the case that Caterpillar was subject to exchange controls which made it unable to use the profits outside Brazil.

<sup>132</sup> The Commission says that this was "without accounting for the effect of integration." Release 30532, *supra* note 126, at 3. It does not say what the effects of integration would have been, although the opinion is written on the assumption that CBSA made an equivalent contribution to Caterpillar's consolidated worldwide earnings. It is possible, of course, that the earnings at CBSA were offset by losses in other parts of Caterpillar's operations. This could happen, for instance, if the rest of the Caterpillar organization shipped components (or even machines) to Brazil at money-losing prices in order to enable CBSA to meet the surge in demand it was experiencing. Following the Commission, the discussion in the text assumes that analysis of the accounting data would show that the CBSA was the origin of more than 20 percent of Caterpillar's consolidated worldwide net income reported for 1989.

would take office in March 1990. Caterpillar's board of directors "was told in February 1990 that Brazil was 'volatile' and that 'the impact of Brazil is so significant to reduced 1990 projected results, [management] felt it was necessary to explain it [to the directors] in some detail.'"<sup>133</sup>

Collar took office in March and immediately took drastic action to deal with Brazil's economic problems. Brazil and CBSA tanked. At the April 11 board meeting, management discussed the effects on Caterpillar.

At our last meeting, we reviewed the impact that [CBSA] is expected to have on our 1990 results. . . . Brazil is volatile and difficult to predict. Their recently announced economic reforms have made the situation even more uncertain. The impact of these reforms is not at all clear, so we have made no attempt to change the forecast. However, it's difficult to see any short-term positives, so there is considerable risk that Brazil's new economic plan could bring additional pressure on our 1990 profit. [Management] . . . also noted . . . that the profit in Brazil will be substantially lower than in 1989.<sup>134</sup>

Meanwhile, Caterpillar was in the process of preparing its form 10-K for 1989 and its form 10-Q for the first quarter of 1990.<sup>135</sup> The 10-K was filed on February 28 and the 10-Q was filed some time after March 31. Under neither the applicable SEC segmentation requirements nor FASB 14 was Caterpillar required to report earnings attributable to Brazil separately.<sup>136</sup> Both the 10-K and the 10-Q mentioned the situation in Brazil, but only in a context that positioned Brazil as one of the many countries in which Caterpillar does business.<sup>137</sup>

---

<sup>133</sup> Release 30532, *supra* note 126, at 2. The opinion does not explain why the subject of developments in Brazil were reported to the Board of Directors. The Board of Caterpillar was unlikely to have much ability to influence events in Brazil. Perhaps management was laying the foundation for a possible future explanation if earnings for the year turned out to be disappointing.

<sup>134</sup> Release 30532, *supra* note 126, at 3.

<sup>135</sup> Caterpillar's timetable for reporting was typical of companies using a calendar fiscal year. Because the financial statements in the 10-K must be audited and the audit can only begin after the close of the year, 10-Ks take several months to complete. The 10-K is required to be filed, however, within 90 days of the end of the fiscal year, Form 10-K, General Instruction A, and must be completed before the solicitation of proxies for the annual meeting. Meanwhile, with the close of the first fiscal quarter on March 31, companies must also prepare and file the 10-Q, which is unaudited.

<sup>136</sup> As the Commission explains, because CBSA constituted less than 10 percent of either the total revenues or assets of Caterpillar. Release 30532, *supra* note 126, at 7, n.9.

<sup>137</sup> The Commission quoted the following statements about Brazil:

On June 25, 1990, before the beginning of trading, Caterpillar issued a press release explaining that the results for 1990 would be substantially lower than previously projected. The press release noted that "more than half of the decrease in forecasted 1990 profit is due to a dramatic decline in results for [CBSA]."<sup>138</sup> The stock opened twenty minutes late at 61 3/8, down 2 1/8. That afternoon, management held a telephone conference with stock analysts beginning at 1:00 p.m. During the telephone conference, with the stock trading at 59 1/4, "Caterpillar revealed CBSA's importance to the company's 1989 earnings."<sup>139</sup> The next day, the stock opened at 51 3/4.<sup>140</sup>

There are many different interpretations that can be offered for these skeletal facts. The facts can be interpreted, for instance, as a case of a failure to correct a previous statement that had become false when the speaker knew that the ad-

---

Sales Outside the United States. . . . Dealer machine sales rose in most selling areas, with demand especially strong in Europe, Brazil, Australia, and the Far East. . . . Latin America Sales rose 14% in 1989, the sixth consecutive year of improvement. The biggest gain was in Brazil, where very high inflation rates increased demand for hard goods, including earth moving equipment. (Given the extraordinarily high rate of inflation in Brazil, many contractors preferred to own hard assets, such as equipment, rather than depreciating cruzados.) Toward year-end, however, sales growth in Brazil moderated as interest rates rose. . . . OUT-LOOK. . . . Latin American countries continue to be plagued with debt problems. However, debt rescheduling; stable profitable commodity prices; and increased privatization should help business in some countries. Sales in Brazil, however, could be hurt by post-election policies which will likely aim at curbing inflation. (10-K). Demand also rose in a number of Latin American countries. In Brazil, demand increased over one year ago despite the uncertainty of the Brazilian economy. . . . The Company hasn't changed its outlook from what was stated in its 1989 annual report. Caterpillar Chairman George Schaefer said: First-quarter sales were somewhat stronger than anticipated. Nevertheless, the company continues to be concerned about tight monetary policies in major industrial countries; the recent weakening of the Japanese yen; and the uncertainty of the economic situation in Brazil. (10-Q).

Release 30532, *supra* note 126, at 9, n. 4.

<sup>138</sup> Release 30532, *supra* note 128, at 4.

<sup>139</sup> Release 30532, *supra* note 126, at 4.

<sup>140</sup> Release 30532, *supra* note 126, at 4. The Commission did not criticize Caterpillar for providing stock analysts preferred access to this information, disfavoring the public, nor did it bring proceedings on an insider-trading theory against anyone who sold as a result of the information revealed in the telephone conference. See Paul B. Bontas Jr., Note, *Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts*, 92 COLUM. L. REV. 1517 (1992), for an analysis of these issues.

dressees of the statement were relying on it as still true. Caterpillar had made its forecasts available to stock analysts. Those forecasts were that the 1990 earnings would be at least as high as the 1989 earnings. The analysts believed the projections and their belief accounted for the stock price. Caterpillar knew that the projections would not be met, possibly as early as March, certainly by April, and it did nothing to correct the beliefs of the analysts based on the forecasts it had provided. The June press release and the conference call surprised the analysts, and caused many of them to recommend selling. That recommendation, in turn, caused the sharp drop in price. Some analysts, no doubt embarrassed by their earlier recommendations based upon the projections, complained to the SEC. The "failure to correct" interpretation, however, was not the theory of the proceeding which the Commission brought against Caterpillar.<sup>141</sup>

Rather, the theory of the proceeding was that Item 303 of S-K, the MD&A section, required Caterpillar to disclose in its 10-K and 10-Q that the past trend of higher earnings in Brazil might not continue, that Caterpillar knew this to be the case, as evidenced by management's communications to the board, and that management knew that a fall in the Brazilian earnings would be material to its overall results.<sup>142</sup>

---

<sup>141</sup> There would be good reasons not to. The stock analysts regularly obtain knowledge of management's internal earnings projections through contacts with management, and through the analysts the information is impounded in the market price. Earnings projections, however, are not provided in Commission filings and written documents, no doubt because of lawyers' fears of 10b-5 liability and managements' fears of leaving a public record of their mistakes. If the Commission took the position that an issuer acquired an obligation, whenever it supplied earnings projection information to persons outside the company, to update those projections continually, that would probably dry up the flow of information about projections altogether. See Bountas, *supra* note 140, for a discussion of these problems. A similar concern about suppressing the flow of information arose in connection with the SEC's 1975 proposal on projections, discussed *supra* text accompanying notes 48-67. The simple defense to the "failure to correct" interpretation would be that Caterpillar simply provided the correct forecasts as of the date they were provided and never suggested that they would remain correct as the year proceeded or undertook to update them when they became obsolete.

<sup>142</sup> Release 30532, *supra* note 126, at 6-9. The opinion points to numerous parts of Item 303 in support of its position, without analyzing or explaining any of them. Three passages in Item 303 and the instructions are most clearly relevant. Item 303(3)(ii): "Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable

The facts, as recited in the Commission opinion, support an interpretation consistent with the Commission's theory. Indeed, the case seems easy. Quoting the metaphor from Securities Act Release No. 6771 that "MD&A is intended to give the investor an opportunity to look at the company through the eyes of management,"<sup>143</sup> the Commission concluded that Caterpillar's board minutes showed that its disclosures had failed to give investors the required "look." But other interpretations are also possible. Earnings of an enterprise are only an artifact of two other figures: revenues and expenditures. Consolidated earnings reflect the difference between these two figures, and it is artificial to say that the difference came from any one place. In 1989, Caterpillar had earnings not only because of the difference between revenues and expenditures in Brazil, but because of the differences elsewhere. To put it another way, the profits in Brazil became earnings for the enterprise only because the other parts of Caterpillar did as well as they did. Further complicating the analysis is that the profits in Brazil may have been an artifact of accounting conventions.<sup>144</sup> A sophisticated analysis would have suggested that

---

impact on net sales or revenues or income from continuing operations." 17 C.F.R. § 229.303(a)(3)(ii) (1995). Caterpillar knew, as evidenced by the Board Minutes, that the situation in Brazil was uncertain, and that a shift in the results in Brazil was likely to have an unfavorable impact on income from continuing operations. The discussion in the text following this note addresses why this might not have been the case.

Item 303(a): "Where in the registrant's judgment a discussion of segment information or other subdivisions of the registrant's business would be appropriate to an understanding of such business, the discussion shall focus on each relevant, reportable segment or other subdivision of the business and on the registrant as a whole." 17 C.F.R. § 229.303(a) (1995). Caterpillar presumably had made a judgment that such a discussion would not be appropriate.

Item 303 Instruction 3: "The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results. . . ." 17 C.F.R. § 229.303, Instruction 3 (1995). Caterpillar could argue that this instruction cannot mean what it says, since reported financial information is never "necessarily indicative of future operating results," and that the contingencies and uncertainties in Brazil were no different in quality than the thousands of other contingencies and uncertainties facing a complex, world-wide business.

<sup>143</sup> Release 6711, *supra* note 119, at 3.

<sup>144</sup> It is impossible to analyze the role that accounting conventions may have played in the results which Caterpillar had for Brazil under U.S. GAAP without more complete information about the nature of the operations, how Caterpillar conducted them, and any hedging strategies it might have employed. Foreign cur-



the 1989 Brazilian results were being achieved at the expense of future profits—that the company would inevitably suffer a post-inflationary hangover. While it would have been economically reasonable to set up a reserve and charge the current earnings against the perfectly predictable after effects, such adjustments are not permitted by the accounting rules.

The real question for Caterpillar in the spring of 1990 was not what would happen in Brazil in 1990. As to Brazil, events would take a course that Caterpillar could neither predict nor control. The question Caterpillar was asking itself in the spring of 1990 was: "What will our reported earnings be in 1990?"

A forecaster attempting to address that question should immediately notice that small changes in the relationship between revenues and costs elsewhere in Caterpillar's business would be far more important than any change that might take place in Brazil. As an example of how the numbers work, consider an enterprise that consists of two components: Component A, accounting for ninety-five percent of the revenues, and Component B, accounting for five percent of revenues. In year

---

rency translation is governed by FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 52: FOREIGN CURRENCY TRANSLATION (1981) [hereinafter "FASB 52"]. Under that standard, operations in an inflationary economy (defined as an economy with inflation over three years in excess of 100 percent, FASB 52, *supra*, at 5, ¶ 11) such as Brazil's was in the relevant time period, are to be reported by using the dollar (the currency of the reporting entity) as the functional currency. FASB 52 *supra*, at 5, ¶ 11. This is essentially the same approach as was previously taken under FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 8: ACCOUNTING FOR THE TRANSLATION OF FOREIGN CURRENCY TRANSACTIONS AND FOREIGN CURRENCY FINANCIAL STATEMENTS (1975) [hereinafter "FASB 8"]. "Implicitly, [in FASB 8] the dollar was designated the functional currency for all foreign operations." FASB 52, *supra*, at 47, App. C ¶ 83. FASB 8 provided generally for the conversion of income and balance sheet figures at the exchange rate of the date of the transaction. It was revised in part because of

the perception that the results of translation under the Statement frequently do not reflect the underlying economic reality of foreign operations. The perceived failure of accounting results to portray the underlying economic circumstances is underscored heavily in two respects: (a) the volatility of reported earnings and (b) the abnormality of financial results and relationship. The sources of both problems are attributed to the requirements for (a) current recognition of unrealized exchange adjustments and (b) that inventories and fixed assets are translated at historical rates under Statement 8, whereas debt is translated at current rates.

FASB 52, *supra* App. D at 71-72, ¶ 53.

one, component B experiences unusually positive results:

Year One			
	Component A	Component B	Enterprise
Revenues	\$10,000	\$500	\$10,500
Expenses	\$9,600	\$400	\$10,000
Earnings	\$400	\$100	\$500

In year two, Component B suffers a large drop in sales due to external factors, but Component A does slightly better:

Year Two			
	Component A	Component B	Enterprise
Revenues	\$10,200 ( 2%)	\$300 (-40%)	\$10,500
Expenses	\$9,600	\$400	\$10,000
Earnings	\$600	-\$100	\$500

These illustrative numbers have the same characteristics as the Caterpillar numbers. In year one, component B (Brazil) accounts for about five percent of the gross revenue of the enterprise, but produces twenty percent of the profit. In year 2, component B experiences a severe loss in revenue and a significant loss as a percentage of its revenue. Yet it takes only a two percent increase in the revenues of the rest of the company for the earnings of the entire enterprise to remain the same. Small changes in the rest of the enterprise can make severe disturbances in one component unimportant for the earnings of the enterprise as a whole.

The second thing a forecaster should realize is that the variability of results for components of Caterpillar is greater than the variability of results for Caterpillar as a whole.<sup>145</sup>

---

<sup>145</sup> One way to illustrate this point is to view Caterpillar at the beginning of 1990 as a portfolio of different securities whose composition will not be changed

The fact that Brazil had unusually positive results in one year is likely to be offset the next year by unusually positive results somewhere else.

For these reasons, it was reasonable for Caterpillar to make the forecast it did at the beginning of 1990, even given the early signs that the business in Brazil would deteriorate. However, it appears to have become clear a few months into the year that there was no identifiable operation that could be counted on to produce a positive surprise in 1990 to offset the negative developments in Brazil. Of course, that surprise might have appeared later. Should Caterpillar have altered its forecasts at that point? That question brings up a great unmentionable: the ability of registrants to manage reported earnings.<sup>146</sup> It is likely that there were a number of possible discretionary decisions that could have been made by Caterpillar during the course of 1990 that would have had the effect of offsetting the negative events in Brazil. Thus, before revising its forecast, Caterpillar had to decide not to meet it.<sup>147</sup> If Caterpillar did not decide until June 25 that it would not, or would be unable to, take steps sufficient to meet its forecast, then it was not timely to make a public statement about a revised earnings forecast before that date.

The most troubling aspect of *Caterpillar* is the use of the management's communications with the board of directors as a measure of what is known by management, and what is material.<sup>148</sup> After *Caterpillar*, registrants are wise to review

---

during the year. An observer of such a portfolio would predict that the variation in the value of the individual securities in the portfolio will be greater than the variation in the value of the portfolio as a whole, because to some unknown extent the securities will offset each other.

<sup>146</sup> Of course the social convention is that managements do not admit managing earnings, they only make discretionary decisions in light of business considerations. A defense along the lines suggested in the remainder of this paragraph would have been embarrassing both to Caterpillar and the Commission, to the probable detriment of Caterpillar.

<sup>147</sup> One possibility is that is exactly what Caterpillar was planning to do, but deteriorating performance elsewhere in the business meant that the available discretionary decisions would no longer have a large enough effect to meet the forecast.

<sup>148</sup> The Commission's approach here parallels that of the Supreme Court in *Basic Inc. v. Levinson*, 485 U.S. 224, 239 (1988), where the Court said:

Whether merger discussions in any particular case are material therefore depends on the facts. Generally in order to assess the probability that the event will occur, a fact finder will need to look to indicia of interest

management's communications with the board of directors to insure that they correspond to the company's SEC filings. If the information fits within Item 303, it will also have to be disclosed to shareholders. One way to prevent communications with the board from flowing immediately to the public-disclosure documents would be for management to adopt a guarded and obscure style with the board: "Management thought the Board might be interested to learn about the unusual developments in Brazil, which have been hard on the Brazilian economy. Caterpillar, of course, has an operation in Brazil, and these developments are hard on the members of the Caterpillar family in Brazil. Management is sure that the Board joins us in extending expressions of sympathy and concern to all Brazilians. Just in passing, you might also be interested to learn that some of the many analyses of our operating results show Brazil as having made an important contribution to our profits last year, so you know that Caterpillareans in Brazil are important members of our family. It looks like they won't be able to help us as much this year, but of course we know that the other worldwide members of the Caterpillar family will be striving to make up the difference. By the way, did you guys see that show on television last night with the talking parrot?" Such a style of communication would address the concern that direct and forceful communication would require disclosure of the information so communicated, but it would not serve the needs of effective board governance. Even more troubling, some managements may be tempted not to communicate with the board at all in order to avoid the public disclosure requirement of Item 303.

Caterpillar made two mistakes. First of all, its communications to the market resulted in a sharp drop in the stock price, an event likely to bring trouble from either the Commission or private litigants.<sup>149</sup> Second, in its conference call to analysts

---

in the transaction at the highest corporate levels. Without attempting to catalog all such possible factors, we note by way of example that board resolutions . . . may serve as indicia of interest.

<sup>149</sup> David S. Ruder, a former Chairman of the Commission, has made it clear that an issuer should have a securities disclosure compliance program designed to prevent unusual trading activity in its stock.

What are the potential negative consequences of poor disclosure policies. Consider only a few. . . . Unusual trading activity in a corporation's

after the press release, Caterpillar mentioned the importance of Brazil to the company's 1989 earnings. No doubt the thought was to downplay the significance of the earnings decline,<sup>150</sup> but when it had reported the 1989 earnings, it had not downplayed their significance by noting that the earnings had been significantly boosted by odd developments in Brazil that were unlikely to continue. In other words, Caterpillar was happy to take advantage of the Brazilian explanation when it suited its purpose, but had ignored it when it did not. If Caterpillar's legal position was to be that the Brazilian factor was unimportant, then it needed to adhere to that position for better and for worse.

Caterpillar agreed as part of its settlement to "implement and maintain procedures designed to ensure compliance with Item 303 of Regulation S-K."<sup>151</sup> What these procedures might be the opinion does not say. The opinion does say, however, that the procedures which Caterpillar had been following were insufficient.<sup>152</sup> The Commission described them as follows:

The MD&A sections of the 1989 10-K and 10-Q for the first quarter of 1990 were drafted by employees in Caterpillar's accounting department. Prior to the issuance of those reports, the language of the MD&A was reviewed by the Controller, Financial Vice President, Treasurer, and the company's legal, economic, and public affairs departments. After that, the language of the MD&A was reviewed by the top officers of the Company.

The board of directors reviewed the final draft of the 1989

---

shares may occur, with resulting inquiry by the SEC of whether company insiders were engaged in trading securities in violation of insider trading restrictions. Even if the corporation itself is not the target of the investigation, the time and emotional involvement of corporate executives can be enormous.

David S. Ruder, *Securities Disclosure*, 6 INSIGHTS 3, (June 1992). The suggestion that intelligent compliance with the securities laws requires that the issuer manipulate the price of its shares so that market action is "normal" is as true as it is ironic.

<sup>150</sup> To judge by the eight-point drop the following morning, this backfired. Perhaps the analysts went home, put on their thinking caps, and said "if this much of Caterpillar's earnings in 1989 were just because of hyperinflation in Brazil, then their real 'core' earnings were more than twenty percent less than they reported, in which case Caterpillar is really worth twenty percent less than it appeared, since the Brazilian earnings were a fluke. Let's see, twenty percent off of 60 is. . . . 48. Sell!"

<sup>151</sup> Release 30532, *supra* note 128, at 9.

<sup>152</sup> Release 30532, *supra* note 128, at 9, n.8.

Form 10-K, including the MD&A, at the February 1990 board meeting. At that time, the board, including top management who were members of the board, received a written opinion of the company's independent auditor indicating that the financial statements complied with the rules and regulations of the Commission, and also an opinion of the company's general counsel to the effect that the Form 10-K complied with all the rules and regulations of the Commission.

The Commission did not say what more Caterpillar was to do. Perhaps it is to form an interdepartmental oversight committee for Item 303, or hire another lawyer specifically to advise on Item 303 compliance.<sup>153</sup> Caterpillar received a slap on the wrist;<sup>154</sup> still, serious questions were raised: Will the SEC

---

<sup>153</sup> In remarks at the 13th Annual Ray Garrett Jr. Corporate and Securities Law Institute, Caterpillar General Counsel Rennie Atterbury recommended "the formation of a disclosure compliance committee to which potentially material information would be reported as received." *Lawyer Advises Telling Firms to Present Balanced Financial Picture*, 25 SEC. REG. & L. REP. (BNA) 662, 662 (May 7, 1993).

<sup>154</sup> Caterpillar and certain of its officers and directors were sued in July 1990 in two class actions filed in the United States District Court for the Central District of Illinois "on behalf of all persons (other than the defendants) who purchased or otherwise acquired common stock of Caterpillar and certain options relating to common stock of Caterpillar, between Jan. 19, 1990 and June 26, 1990. . . . The complaints allege that the defendants fraudulently issued public statements and reports during the class period which were misleading in that they failed to disclose material adverse information relating to Caterpillar's Brazilian operations, its factory modernization program and its reorganization plan." Form 10-K for the Caterpillar Corporation for the Year Ending Dec. 31, 1992, at 7, Item 3, filed March 3, 1993. The class actions are pending. See *Kas v. Caterpillar, Inc.*, 815 F. Supp. 1158 (C.D. Ill. 1992); *Margolis v. Caterpillar, Inc.*, 815 F. Supp. 1150 (C.D. Ill. 1991).

The impact of the SEC action on the class action (which may result in the payment of substantial sums by or on behalf of Caterpillar) is unclear. The class action was filed within weeks of the June 25 announcement. At that point the SEC proceeding could only have been at a preliminary stage. It is not uncommon for a securities fraud action to follow any rapid change in the price of an issuer's stock, particularly a decline. The SEC settlement order is based only on a violation of the reporting requirements contained in Securities and Exchange Act § 13(a), 15 U.S.C. § 78m(a) (1995). The class plaintiffs, on the other hand, will have to show a violation of Securities and Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1995), and a resulting loss from the violation. At the very least, the fact that Caterpillar has agreed that its disclosures were in violation of the Act will assist the "atmosphere" of the lawsuit in a manner favorable to plaintiffs. More likely, the plaintiffs might allege a theory of a continuing but misleading representation that Caterpillar's disclosures were in compliance with the requirements of the

continue to engage in a low-level wrestling match with issuers, or will it escalate its campaign to ensure that security holders are able to "look at the company through the eyes of management?"<sup>155</sup> What further consequences might be in store for an issuer that fails to identify the known trends required by Item 303? The SEC could proceed directly against the issuer and the responsible officers and directors,<sup>156</sup> or recommend the matter for criminal prosecution.<sup>157</sup>

#### D. Materiality and the Basic Case

*Basic Inc. v. Levinson*<sup>158</sup> was a class action under Rule 10b-5 by sellers complaining that they had sold for too little. They had sold just before the issuer agreed to a merger that gave shareholders a premium over the market price. They sued on the theory that they had lost the premium because the

---

Exchange Act, and that their failure to comply caused the plaintiff harm. See *In re Compaq Sec. Litig.*, 848 F. Supp. 1307 (S.D. Tex. 1993). For purposes of perspective, members of the plaintiff class who purchased Caterpillar stock in the 60's during the spring of 1990 (the high in 1990 was 68 1/2 in June, in 1989 it was 69 in January) and who have since held the stock now own stock trading (as of September 22, 1994) at a price equivalent to 108. The stock split 2-1 on September 6, 1994. Any recovery in the class action will be in addition to this gain. The low in 1990 was 38 1/8 in October, and any member of the plaintiff class who was swift enough to sell when trading opened on June 26 (at 51 3/4) and repurchase in October will have an even larger gain. All price data are from the historical quotes (//HQQ) file of Dow Jones News Retrieval.

<sup>155</sup> Release 6711, *supra* note 119, at 3. Other SEC enforcement actions involving failure to comply with the MD&A requirement are discussed in Bruce A. Hiler & Roger M. Freeman, *Management's Discussion and Analysis: Known Trends in SEC Enforcement*, 8 INSIGHTS, December 1994, at 11.

<sup>156</sup> Under Securities Exchange Act § 21C, 15 U.S.C. § 78u-3 (1995), or Securities Exchange Act § 15(c)(4) (1995), 15 U.S.C. § 78o(c)(4) (1995). The SEC made an officer a party in *In re Salant Corp. & Martin F. Tynan*, Exchange Act Release, 1994 WL 183411 (S.E.C.) (May 12, 1994).

<sup>157</sup> Securities Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1995). The penalty for a violation is a fine of not more than \$1,000,000 and imprisonment of not more than 10 years for natural persons, and a fine of not more than \$2,500,000 for other than natural persons. *Id.* A private cause of action under Rule 10b-5 for a failure to comply with Item 303 (and any other SEC disclosure requirement) could be advanced on the theory that a company registered under the Exchange Act makes a continuing representation that it will comply with the SEC disclosure requirements, and that a failure to comply with any of those requirements makes that continuing representation a misrepresentation in violation of Rule 10b-5. See also *supra* note 154.

<sup>158</sup> 485 U.S. 224 (1988).

issuer misled them.

During the period that the class was selling, the merger was the subject of on-again and off-again negotiations. The company's stock (listed on the New York Stock Exchange) experienced unusual trading activity. Traders had either guessed or learned of the possibility of a merger at a premium, and were taking positions in the stock. Partly in response to inquiries from the Exchange,<sup>159</sup> the company stated that it knew of no reason for the activity in its stock. The statements were true in a literal sense because the company did not know who was buying its stock, or why, and no negotiations were taking place or were scheduled at the time the statements were made. On the other hand, the company did know that merger discussions had taken place, that merger remained a real possibility, and that it was likely one or more traders had figured that out.<sup>160</sup>

One of the many defenses in the case was that the statements of the defendant were not material, as required for an action under 10b-5.<sup>161</sup> The trial court granted summary judgment to the defendant on this issue, relying on circuit authority that the fact of merger negotiations prior to an agreement in principle is not material.<sup>162</sup> The Sixth Circuit reversed. The Court reasoned that once the issuer made the statement that it knew of no reason for the activity in its stock, information that negotiations in fact had taken place became material and,

---

<sup>159</sup> *Id.* at 227, n.4. Statements were also made in filings required by the Exchange Act.

<sup>160</sup> The district court entered summary judgment for the defendants on the ground that the statements were not misleading. See Brief for Petitioners at 11-12, *Basic v. Levinson*, 485 U.S. 224 (1988) (No. 86-279). This was reversed by the Sixth Circuit without analysis of the record. *Basic v. Levinson*, 786 F.2d 741, 747 (6th Cir. 1986). The reversal by the Supreme Court of the decision of the Sixth Circuit can be interpreted as a reversal of the grant of summary judgment on the ground that the issue of the misleading nature of the statements could not properly be resolved by summary judgment. That was the position argued in the amicus brief of the Securities and Exchange Commission. Brief of the Securities and Exchange Commission as Amicus Curiae at 19, No. 86-279. *Basic v. Levinson*, 485 U.S. 224 (1988) [hereinafter "SEC Amicus Brief"].

<sup>161</sup> Rule 10b-5(2) requires either (1) the making of any untrue statement of a material fact or (2) the omission of a material fact that would render statements made not misleading.

<sup>162</sup> *E.g.*, *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985). See also *Flamm v. Eberstadt*, 814 F.2d 1169 (7th Cir. 1987), *cert. denied*, 484 U.S. 853 (1987) (decided after the district court decision in *Basic*).



thus, had to be disclosed. According to the Sixth Circuit:

When a company whose stock is publicly traded makes a statement, as Basic did, that "no negotiations" are underway, and that the corporation knows of "no reason for the stock's activity," and that "management is unaware of any present or pending corporate development that would result in the abnormally heavy trading activity," information concerning ongoing acquisition discussions becomes material by virtue of the statement denying their existence. The "reasonable investor," having been informed that Basic knew of no corporate development that would result in the high trading activity, would, without doubt, have thought that disclosure of the fact that acquisition was being discussed "significantly altered the 'total mix' of information made available."<sup>163</sup>

The Supreme Court granted certiorari to resolve a conflict with the Third Circuit.<sup>164</sup> Once the case was in the Supreme Court, the Court's instinct to make law,<sup>165</sup> rather than to de-

---

<sup>163</sup> *Basic*, 786 F.2d at 748.

<sup>164</sup> *Greenfield*, 742 F.2d 751 (3d Cir. 1984). The conflict with the Third Circuit had to do, however, with whether the statement that "management knows no reason" was false or misleading. See *Basic*, 786 F.2d at 748. This issue was addressed only briefly in the opinion of the Supreme Court. The Court stated, "We accept the Court of Appeals' reading of the statement [rather than that of *Basic Inc.*] as the more natural one, emphasizing management's knowledge of developments (as opposed to leaks) that would explain unusual trading activity." *Basic*, 485 U.S. at 240 n.20. Although the Court agreed with the Sixth Circuit that the statement was misleading, it nevertheless vacated the circuit court judgment and remanded for reconsideration "because the standard of materiality we have adopted differs from that used by both courts below." *Id.* at 240-41. Since the district court had applied a different standard a remand was appropriate. I cannot detect any difference between the standard used by the Sixth Circuit and that announced by the Supreme Court. On remand, the Sixth Circuit observed, "Based upon the facts of this case, it is difficult for us to see how *Basic's* multiple public statements denying merger talks which substantially affected the activity of the stock were not material." *Levinson v. Basic*, 871 F.2d 562, 564 n.1 (6th Cir. 1989).

<sup>165</sup> In *Basic* this effort resulted in a shambles, as Victor Brudney patiently and politely explains. According to Brudney: "In *Basic Inc. v. Levinson*, the Supreme Court entered the thicket of doctrine that governs disclosure of soft, or future-oriented, information to investors under the federal securities laws, but regrettably did not take advantage of the opportunity to remove any of the brambles or to make the thicket more penetrable." Victor Brudney, *A Note on Materiality and Soft Information under the Federal Securities Laws*, 75 VA. L. REV. 723, 723-24 (1989). A less tactful statement would be: "failed to remove any of the brambles or to make the thicket more penetrable in spite of writing an opinion that sounded as if it were." It should be added that the opinions of the lower courts, which might have provided some assistance to the Court, also tended to be quite confused. The opinion correctly observed that "In some of these [lower court] cases it is unclear whether the court based its decision on a finding that no duty arose to reveal the existence of negotiations, or whether it concluded that the negotiations

cide cases, took over. An opinion that simply relied on the Sixth Circuit's rationale would have said little more than: "lies about significant matters violate the securities laws." The opinion of the Court written by Mr. Justice Blackmun, however, addressed the general question of when information about merger negotiations becomes material, regardless of whether the issuer makes any statement at all. The Court noted that the approach of the Sixth Circuit "fails to recognize that, in order to prevail on a Rule 10b-5 claim, a plaintiff must show that the statements were misleading as to a material fact. It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant."<sup>166</sup>

The opinion in *Basic* is best understood by describing four different contexts in which the issue of materiality is relevant to the issues discussed in the opinion. The four contexts are: (1) disclosure defining; (2) insider-trading defining; (3) implied-cause-of-action defining; and (4) free-standing.

### 1. Materiality Defines The Scope of Required Disclosures: Rule 408

This definitional function of materiality is described in Rule 408. Rule 408 provides that:

In addition to the information expressly required to be included in a registration statement [under the applicable regulations], there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circum-

---

were immaterial." *Basic*, 485 U.S. at 233 n.10. Brudney, whose conclusions are (I think) congruent with those offered here, undertakes to explain the difficulties with the opinion in a quite different way. The way he makes the point is to argue that there are normative considerations buried in the application of the materiality doctrine that the Court ignores. Brudney, *supra*.

<sup>166</sup> *Basic*, 485 U.S. at 238. This view of the issue in the case was argued in the amicus curiae brief filed by the SEC Amicus Brief, *supra* note 160 at 18-19. The Court did not explain why any reasonable investor would not consider it important to learn that the issuer lies when making public statements, since the credibility of the issuer's communications is of central importance to any investor. It is possible to read Rule 10b-5 as not requiring that a misleading statement be material. It provides: "It shall be unlawful for any person . . . (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b-5(b)(1995) The issue is whether "the statements made" refers only to material statements, or to any statement.

stances under which they are made, not misleading.<sup>167</sup>

The point here is that the responses provided in disclosure forms should disclose the full truth. The telling of half-truths by failing to mention additional information which affects the meaning of the information that is disclosed is prohibited.

This standard can be generalized to apply to any statement. In fact, that was what the Sixth Circuit was doing in *Basic*. *Basic* had made a disclosure, and the question was whether that disclosure was misleading because of the failure to disclose the additional material information necessary to make the statement, in light of the circumstances under which it was made, not misleading.

## 2. Materiality Defines the Scope of the Insider Trading Prohibition

This is the "disclose-or-abstain" insider trading rule of *Texas Gulf Sulphur*: persons who possess material inside information about the issuer cannot trade unless the material information has been disclosed. Insiders can, however, trade while in possession of nonmaterial inside information.

## 3. Materiality Defines the Scope of the Implied Right of Action Under Rule 10b-5.

In this context, the concept of materiality as a definition of the implied right of action under Rule 10b-5, has a function like that of the concept of materiality in the common law action for misrepresentation.<sup>168</sup> This was the context actually at

---

<sup>167</sup> 17 C.F.R. § 230.408 (1995), which applies to prospectuses filed under the Securities Act. Rule 12b-20, 17 C.F.R. § 240.12b-20 (1995), applies the same requirement to filings under the Exchange Act. Note that this standard echoes the second clause of Rule 10b-5(2), except that "required statements" (whether or not material) replaces "statements."

<sup>168</sup> The Restatement (Second) of Torts 2d § 538 (1977) provides:

(1) Reliance upon a fraudulent misrepresentation is not justifiable unless the matter misrepresented is material. (2) The matter is material if (a) a reasonable man would attach importance to its existence or nonexistence in determining his choice of action in the transaction in question; or (b) the maker of the representation knows or has reason to know that its recipient regards or is likely to regard the matter as important in determining his choice of action, although a reasonable man would not so

issue in *Basic*: can these plaintiffs bring an action for losses caused by the failure to disclose the merger negotiations?<sup>169</sup> It is the only context which makes sense of prior circuit court decisions holding that the existence of merger negotiations prior to an agreement in principle is not material. Those decisions implemented the judgment that, on the whole, it would be better to let issuers faced with a demand from the Exchange that they make a statement about unusual activity in their stock equivocate rather than disclose merger negotiations when the effect of the disclosure might be to reduce the chance that the negotiations would succeed, to the benefit of all the shareholders.<sup>170</sup>

This third context of materiality was argued implicitly in the *Basic* case. The idea that the scope of the implied cause of action under Rule 10b-5 can be narrower than the prohibition of Rule 10b-5 itself is only now beginning to emerge as a possibility in the Supreme Court's Rule 10b-5 decisions. The Court's 10b-5 cases have tended to insist that it is doing nothing more than reading the text of the statute and the rule. In the *Central Bank of Denver*<sup>171</sup> decision, the Court distinguished between the scope of the prohibition of 10b-5, which is resolved by the text of the statute, and "determining the elements of the 10b-5 private liability scheme," which is resolved by asking "how the 1934 Congress would have addressed the issue[s] had the 10b-5 act been included as an express provision of the [Exchange] Act."

---

regard it.

*Id.*

<sup>169</sup> In this context, the issue of materiality was fundamentally the same as the second issue considered by the Court in *Basic*: whether a class could be certified as the result of presuming reliance by all members of the class under the fraud-on-the-market theory. The fundamental issue in both parts of the opinion is whether it would further or hinder the purposes of the securities law to permit actions of the type brought in *Basic* to proceed to trial. For an analysis of the class certification issue in these terms, see Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623 (1992).

<sup>170</sup> This was the most persuasive justification. See the discussion by Judge Frank Easterbrook in *Flamm v. Eberstadt*, 814 F.2d 1169, 1175-76 (7th Cir. 1987), cert. denied, 484 U.S. 853 (1987). The courts also expressed concern that speculators would misunderstand accurate information about merger negotiations. They also worried about the practicalities for the issuer of attempting to comply with an unclear legal rule as to when negotiations become material.

<sup>171</sup> *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 128 L.Ed.2d 119 (1994).

In both of the formulations the Court insists that it is not itself shaping the scope of the implied right of action. Yet the Court makes reference to policy considerations based on concerns about contemporary 10b-5 litigation that have nothing to do with the 1934 Congress. As Joel Seligman has noted, "This is legal fiction."<sup>172</sup> The strongest argument for the defendants in *Basic* was that even if their statements about merger negotiations violated Rule 10b-5, it would be contrary to the purposes of the Exchange Act—to shareholder welfare—to permit an implied private right of action to proceed based on the statements. The Court could have held that the statements were not material solely for purposes of the implied right of action, without addressing questions with any larger implication for the administration of the securities laws.<sup>173</sup>

#### 4. Materiality is Defined Without Regard to Any Disclosure Obligation, the Presence of Insider Trading, or the Scope of the Implied Cause of Action

This is the context that the Court said it was addressing in *Basic*.<sup>174</sup> In *Basic* the Court noted that it was analyzing

---

<sup>172</sup> Joel Seligman, *The Implications of Central Bank*, 49 BUS. LAW. 1429, 1432 (1994). The Court's insistence that it is only reading the text of the statute creates other problems. Not only is there the issue of the application of the 10b-5 decisions to Commission enforcement actions, discussed by Seligman, *id.* at 1434-35, but there is also its impact on the other rules, for example 10b-6, promulgated under § 10(b). See Fred N. Gerard & Michael L. Hirshfeld, *The Scienter Requirement Under Rule 10b-6*, 46 BUS. LAW. 777 (1991). Rule 10b-6 does not require scienter, although the Supreme Court construed the statute as requiring scienter in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). For persuasive arguments (to this author) that the Court's avowed literal reading of 10b-5 is simply wrong, see Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990).

<sup>173</sup> Joseph A. Grundfest, *Disimplying Private Rights of Action under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 1013 (1994), argues that the SEC could "redefine 'materiality' to require a stronger market effect than the courts currently mandate." Surely, in the absence of SEC action the Court, whose decisions provide the foundation for the 10b-5 implied right of action, could also adopt a definition of materiality applicable to the implied right of action.

<sup>174</sup> See *supra* text accompanying note 166. In another passage the opinion seemed to define the issue in the disclosure-defining context: "[T]his case does not concern the timing of a disclosure; it concerns only its accuracy and completeness." *Basic v. Levinson*, 485 U.S. 224, 235 (1988). The way the opinion poses the issue is shaped by the lower court decisions, which discussed the issue of whether there

the free-standing context, ignored the implied cause-of-action context, and asserted that the meaning of materiality in the free-standing context was the same as the meaning of materiality in the disclosure and insider-trading contexts.

In the insider-trading context, it is inconceivable that the Court would hold that merger negotiations were not material. The issue is whether an insider, knowing that merger negotiations were underway and looking to the consummation of a merger at a significant premium over the price of the issuer's stock, could proceed to purchase shares of the issuer on the market. Obviously not, because the fact of merger negotiations is the kind of confidential material that insiders should not be permitted to exploit for their own gain.<sup>176</sup>

Similarly, in the disclosure context, it is inconceivable that the Court would hold that an issuer could fail to disclose the fact of merger negotiations when such a failure would render the information provided misleading.

The important difference between materiality in the free-standing context as addressed by the Court and materiality in the disclosure and insider-trading contexts is that in the latter contexts materiality has meaning.

In the disclosure context, the disclosure forms or the statement made provide the context for application of the materiality test. Is something material in relation to the information that the SEC requires, or the statement that is being made, that must be included in order to keep the answer or the state-

---

was a duty to disclose merger negotiations without identifying the source of the duty. Quite correctly, the Supreme Court opinion reasoned that the duty did not arise unless it was imposed by some provision of the securities laws. *Id.* at 236. The lower courts were probably thinking of a continuing representation theory under Rule 10b-5. For instance, the statement that "we are not involved in merger negotiations" becomes false once serious merger negotiations begin. If the obligation to file a 10-Q or a 10-K itself creates a duty to disclose, however, then the timing differences between a duty to disclose based on a continuing representation and a duty to disclose based on the Exchange Act filing requirements is not of great significance.

<sup>176</sup> This presented the defendants in *Basic* with their central strategic problem. Since 10b-5 prohibits transactions based on material inside information, and 10b-5 clearly prohibits insiders from trading based on inside information relevant to the ex-ante probability that a merger will take place, then surely information relevant to the ex-ante probability that a merger will take place is material. They did not undertake to counter this argument until their reply brief. See Reply Brief for Petitioners at 3-7, *Basic v. Levinson*, No. 86-279, 485 U.S. 224 (1988).

ment from being misleading? In this context, materiality simply prohibits lying.

In the insider-trading context, materiality has to do with the bar against insiders profiting from inside information. It deals with the question: When has enough information been disclosed so that insiders are free to trade?

In both the disclosure and the insider-trading contexts, the test for materiality can be quite expansive without creating obvious problems; in the disclosure context because the concept is limited operationally by the content of the disclosure form or statement involved; in the insider-trading context because the problem of insider trading can be avoided altogether if the insiders abstain from trading.

The *Basic* Court asserted, "We find no authority in the statute, the legislative history, or our previous decisions for varying the standard of materiality depending on who brings the action or whether insiders are alleged to have profited."<sup>176</sup> Authority aside, there are good arguments for varying the standard. First of all, insider trading presents a conflict-of-interest situation. Insider trading suggests that management has incentives to make a decision to serve its own interests by telling too little. In that context it makes sense to require that management's disclosure meet a more exacting standard, an approach that would be congruent with many other doctrines in corporate law. Second, insider trading does provide a context in which to ask the materiality question. After all, as the court pointed out in *Texas Gulf Sulphur*, if disclosure would harm the corporation, all the insiders have to do is refrain from trading. In the absence of insider trading there is no conflict of interest, and there is no time-specific and situation-specific context in which to ask the question.<sup>177</sup>

When the Court comes to defining materiality, it draws

---

<sup>176</sup> *Basic*, 485 U.S. at 240 n.18.

<sup>177</sup> The only reason the Court gives for its insistence that there must be "one standard" is as follows: "Devising two different standards of materiality, one for situations where insiders have traded in abrogation of their duty to disclose or abstain (or for that matter when any disclosure duty has been breached), and another covering affirmative misrepresentations by those under no duty to disclose (but under the ever-present duty not to mislead), would effectively collapse the materiality requirement into the analysis of defendant's disclosure duties." *Id.* I am unable to make sense of that sentence.

upon definitions developed under the disclosure context and the insider-trading cases. In both of these contexts, the standard of materiality can be more expansive; in the disclosure context because it is constrained in practice by a particular disclosure, and in the insider-trading context because its application is limited. In *Basic*, the Court asserted that "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information."<sup>178</sup> The Court, however, says nothing about the characteristics of the reasonable investor. The accuracy-enhancement concept (to return to the main theme), however, hovers just off stage to fill the gap: the reasonable investor is an investor who attempts to identify undervalued securities (to buy) and overvalued securities (to sell). In short, the information a reasonable investor would consider significant is information relating to the value of the security. That idea is certainly present in *Texas Gulf Sulphur*, on which the *Basic* Court heavily relies. According to the *Texas Gulf Sulphur* Court, "material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities."<sup>179</sup> Significantly, however, the *Basic* Court's reasonable investor appears to have no concern for the costs involved in producing the information, or in the possibility that the production of the information might harm the issuer.

The unresolved issue after *Basic* thus becomes whether, given the fact that the Court thinks materiality is a single concept, the Court's definition of materiality is now the definition for the disclosure context. If so, are all the SEC forms now to be read as requiring registrants to disclose to investors all the information the SEC asks for, plus everything that the reasonable investor would like to know? More specifically, does *Basic* mean that every time an issuer is required to file a 10-K or a 10-Q it must disclose all ongoing merger negotiations? Can *Basic*, together with the MD&A disclosure requirements as interpreted in *Caterpillar*, be read as a call, even a require-

---

<sup>178</sup> *Id.* at 240.

<sup>179</sup> *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).



ment, for implementation of the accuracy-enhancement concept each time a filing is required? If it can be so read, will either the Commission or the Court read it that way?<sup>180</sup>

### E. *Market Valuation of Assets*

Efforts to require the disclosure of the market value of assets promote accuracy enhancement. One way for a business to generate cash flow is to sell its assets, and the amount of those cash flows depends on the price that the assets would bring if sold. Yet balance sheets disclose historic costs, not current values. That makes the accounting disclosures an unreliable guide to predictions of the possible cash flows that could be generated by sales. Homer Kripke listed the SEC's insistence on cost-based accounting as the first example of a deep-seated attitude that the SEC "must reverse."<sup>181</sup> This issue remained dormant until the late 1980's.

That the SEC has become a champion of current-value accounting is ironic. Cost-based balance sheets have been one of the central items of faith in the Commission's historic insistence on "objective" accounting,<sup>182</sup> on the theory that if assets can be revalued, and management is in charge of that process, then management can use revaluation to affect reported results. The SEC has now abandoned that objection to the use of current values. Since the arrival of Richard Breeden in 1989, the Commission has insisted that the Financial Accounting Standards Board ("FASB") adopt standards that require in-

---

<sup>180</sup> A recent statement by one SEC Commissioner suggests that he at least understands the disclosure system in this way. "The full disclosure system requires disclosure of all known factors that would influence an investor's decision to buy or sell securities." Richard Y. Roberts & Kurt R. Hohl, *Environmental Liability Disclosure and Staff Accounting Bulletin No. 92*, 50 BUS. LAW. 1, 14 (1994). Roberts was sworn in as a Commissioner of Securities and Exchange on Oct. 1, 1990, for a term expiring June 5, 1995. *Roberts Sworn in as New Commissioner; SEC Returns to Full Five-member Lineup*, 22 SEC. REG. & L. REP. (BNA) 1417 (October 5, 1990), and *Bush Nominates Richard Roberts, Former Senate Aide, to Be SEC Member*, 22 SEC. REG. & L. REP. (BNA) 1159 (August 10, 1990).

<sup>181</sup> Kripke, *supra* note 38, at 1188-97.

<sup>182</sup> For the history of the development of the SEC's policy against use of current values in accounting statements and documents filed with the Commission in the period between its formation and the early 1940's see R.G. Walker, *The SEC's Ban on Upward Asset Revaluations and the Disclosure of Current Values*, 28 ABACUS 3 (Mar. 1992). See also KRIPKE, *supra* note 6, at 179-84.

creased use of current value. The SEC has justified this change of position on accuracy-enhancement grounds.

The concept of income as the difference between the value of assets at the opening of the period and the closing of the period is one long accepted by economists. They commonly refer to a definition offered by John Hicks: "A man's income is the maximum value which he can consume during a week, and still expect to be as well off at the end of the week as he was at the beginning."<sup>183</sup> This definition of income can only be calculated and reported if the value of the issuer's assets is determined at both the opening and ending of the accounting period.

There are two important problems in translating the economist's definition of income into a workable accounting system. One is that the business does not have a need, in the normal course of its business, to collect information on the current value of assets. If the asset is necessary to carrying on the business, management need not regularly determine at what price the asset could be sold. Thus value accounting imposes significant additional costs.

The second important problem arises if accounting is thought to serve as a gauge of management's performance, as management's "report card." Management can take the position that it did not acquire the asset in order to sell it at the end of any particular accounting period. Management may claim that it acquired an asset to use in the business; that it was needed. Accordingly, management may assert that buying the asset was a good decision, even though there was some chance that its value might suddenly decline, because it has been a productive asset for the company. Even as to securities, management can argue that particular securities were bought because of management's assessment that they would be a good investment over the long run. The truth or falsity of that

---

<sup>183</sup> JOHN R. HICKS, *VALUE AND CAPITAL* 172 (2d ed. 1939). This is also what is widely known as the Haig-Simons definition of income, developed for purposes of analysis of the income tax. HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* (1938) and Robert M. Haig, *The Concept of Income*, in *THE FEDERAL INCOME TAX* (Robert M. Haig, ed. 1921). Academic accountants recommended that the accounting profession work from this concept of income in the early 1960s. The profession rejected this suggestion. See Kripke, *supra* note 38, at 1190 & 1190 n.161 and KRIPKE *supra* note 6, 191-98.

assessment will only be known when the security is sold, even if prices fluctuate in the interim.

Whatever role current value should play in a system of accounting, the FASB—at the SEC's explicit urging—has now ended up with a mixed system in which a few items on the balance sheet are valued at market. To the extent that the purpose of a balance sheet is to arrive at an estimate of net worth, it is odd to use current value for only a portion of the balance sheet. To mix value accounting and cost-based accounting in the same balance sheet is to end up with a hybrid net worth whose meaning is very unclear. That is exactly what has happened.

The SEC sent a clear signal to the FASB that something was to happen through testimony in 1990 by its then-Chairman, Richard Breeden, before the Senate Committee on Banking, Housing, and Urban Affairs. The hearings were entitled *Banking Regulators' Report on Capital Standards*, but their real subject was the savings-and-loan crisis, a matter on which Breeden had worked in his previous position in the White House. Breeden (and apparently the Commission)<sup>184</sup> used his prepared testimony as a call for market-value accounting. Breeden testified that:

Steps currently being taken to clarify the accounting treatment for investment portfolios should be part of a broader move in the direction of mark-to-market accounting. The benefits of market-based accounting warrant consideration of a broader shift in this direction. The presumption that market-based information is the most relevant financial data attribute should be recognized. It may be appropriate to utilize historical cost only where specifically justified by the circumstances in the future.<sup>185</sup>

In his oral testimony, he was more colorful:

I do have some comments later on the general subject of mark-to-

---

<sup>184</sup> In an interview, Breeden asserted that "the testimony that I gave before the Senate was the unanimous testimony of the Commission, so let that speak for the record. We do have the final authority over what must be disclosed in accounting statements by public companies." Dana Wechsler Linden, *If Life is Volatile, Account for It*, FORBES, Nov. 12, 1990, 114 at 114-21.

<sup>185</sup> *Banking Regulators' Report on Capital Standards: On Capital Requirements and Accounting Rules that Determine What Counts as Capital in our Banking System, Hearings before the Senate Comm. on Banking, Housing and Urban Affairs*, 101st Cong., 2nd Sess. 97, 155 (1990) [hereinafter "*Capital Standards Hearings*"].

market accounting, but I think that, particularly in financial institutions, whose portfolios consist of financial instruments that have, in many cases, a readily ascertainable value, certainly in the securities portfolios, it would be regrettable if we continued to have accounting statements that essentially needed to have at the top of the balance sheet the phrase "once upon a time." . . . And maybe "in the galaxy far, far away." I mean, we know that what's important is the economic worth of this institution and not what it once looked like whenever it made investment decisions for its portfolio—perhaps many, many years ago. That really, other than to historians, is of relatively little importance.<sup>183</sup>

Breeden was not subtle about why the accounting profession should pay attention. He added:

The Chairman [Senator Donald W. Riegel, Jr. of Michigan]: Why shouldn't the SEC set the accounting rules? What is the rationale for allowing the Financial Accounting Standards Board to [do] that in effect for you?

Chairman Breeden: Well, we have ultimate authority over the accounting principles that are promulgated. . . . [We] think we . . . have to realize . . . that we have a responsibility, that we cannot necessarily just stand back and say that we will wait until the principles are presented to us. There are areas, such as the issue of whether we should be moving toward market value accounting at a more brisk pace<sup>187</sup> than has occurred in recent years, where I think the Commission needs to consider appropriate policies and at least make sure that those issues are being fully considered by the professional accounting bodies.<sup>188</sup>

Breeden's testimony suggests that his commitment to market-value accounting reflects the belief that if market-value accounting had been in effect in the 1970s, the savings-and-loan crisis would have been prevented.

The theory that market-value accounting would have prevented the savings-and-loan crisis is as follows: the fact that

---

<sup>185</sup> *Capital Standards Hearings*, *supra* note 185, at 109.

<sup>187</sup> Question: "What time frame do you have in mind? I don't see any particular obstacles to having the year-end 1991 financial statements include market values." Linden, *supra* note 184, at 121. FINANCIAL ACCOUNTING STANDARDS BOARD, EXPOSURE DRAFT, PROPOSED STATEMENT OF FINANCIAL ACCOUNTING STANDARDS: DISCLOSURES ABOUT MARKET VALUE OF FINANCIAL INSTRUMENTS, FASB No. 093-E (Dec. 31, 1990) became FASB 107 in December, 1991. FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 107, DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS (1991) [hereinafter "FASB 107"].

<sup>188</sup> *Capital Standards Hearings*, *supra* note 185, at 109.

the thrift industry had become insolvent in the early 1970's was hidden from the regulators and the public because their assets (almost entirely fixed-rate home-mortgage loans) were carried on their books at cost, which was higher than their value because of rising interest rates. Under market-value accounting, the insolvency of each thrift would have become apparent, one at a time. As the insolvency became apparent, the thrift would have been forced either to close or to raise more capital. Instead, the problem quietly mushroomed until it became too big to confront. At that point, Congress and the regulators were conscripted into a scheme to hide it even longer by permitting the industry to use accounting rules even more unrelated to reality than cost-based accounting, among other things.<sup>189</sup>

This argument requires a sophisticated and complex theory which relates the degree of visibility of an issue to the formation of the agendas of politicians. That theory, however, involves a leap in logic. Although the savings and loans did not publicly report their insolvency in the 1970s, it took only a back-of-the-envelope calculation to realize that the thrifts were already insolvent.<sup>190</sup> At that time they held fixed-rate home-

---

<sup>189</sup> The most extraordinary departure from GAAP was in 1981, when the regulators (with Congressional urging) decided to allow the savings and loans to defer the recognition of losses on the sale of assets, and to write them off over a period of ten years. This episode is discussed in Chairman Breeden's testimony. *Capital Standards Hearings*, *supra* note 185, at 100-01, 137-39. This accounting change and other changes, including a tax benefit, gave the thrifts strong incentives to sell their existing mortgage portfolio and replace it with another mortgage portfolio, even though the economic return on the two portfolios was the same. That meant that all of the thrifts then wanted to sell their own mortgage portfolios and buy someone else's. The scene when the demand for these transactions hit the trading floor at Salomon Brothers, and the resulting profit to Salomon, is portrayed in MICHAEL LEWIS, *LIAR'S POKER: RISING THROUGH THE WRECKAGE ON WALL STREET* 103-09 (1989). LAWRENCE J. WHITE, *THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION* 82-87 (1991) describes all of the accounting changes made by the Congress and the regulators designed to further "conceal" the condition of the thrifts.

<sup>190</sup> Retrospective estimates are provided in EDWARD J. KANE, *THE S & L INSURANCE MESS: HOW DID IT HAPPEN?* 75-76 (1989). Kane estimates that the industry had a negative net worth as early as 1971. Lawrence J. White provides an overview of the series of economic and regulatory events lying behind the S&L problem. Of the position of the thrifts in the late 1970's he says:

Accordingly, as the thrift industry entered into the late 1970s the thirty-year fixed-rate mortgage was still the standard asset for the industry, and the industry was still borrowing short and lending long. The recom-

mortgage loans which they had made, and interest rates had risen since the mortgages had been issued. Necessarily, their value had fallen. The industry knew it was economically insolvent. Commentators knew the industry was insolvent. But how would the situation have been different if this insolvency had appeared on market-value balance sheets? Would not the same political pressures which led the regulators and Congress to shove the problem under the rug in the hope of some better day have also been at work then? Wouldn't they have been just as likely to permit a deviation from market-value accounting principles as they were to ignore the problem with cost-based balance sheets?<sup>191</sup>

Whatever the accuracy of the diagnosis, market-value reform was to be. The first result was FASB 107, Disclosures about Fair Value of Financial Instruments, issued in December 1991.<sup>192</sup> FASB 107 requires the disclosure, in gross categories, of the fair value<sup>193</sup> of all financial instruments either

recommendations of a number of study groups and commissions during the 1970s—that Regulation Q be phased out, that thrifts be allowed to offer ARMs [adjustable rate mortgages], and that they be allowed to diversify into other activities—were ignored. The industry, its regulators, and the Congress clung to Regulation Q [which limited the interest payable on deposits] as the solution to the industry's problem.

Regulation Q, however, only delayed the day of reckoning for the thrift industry. In the late 1970s, as interest rates again rose—this time much more sharply—the thrifts again faced a set of choices that meant unavoidable losses, but Regulation Q could no longer save them.

WHITE, *supra* note 189, at 65.

<sup>191</sup> Breeden in his testimony reported that the regulators permitted deviations from GAAP in order to strengthen thrift balance sheets in 1972. The same episode is described in WHITE, *supra* note 189, at 83-84. *Capital Standards Hearings*, *supra* note 185, at 127-28. White joins Breeden in recommending current value accounting, although only for financial institutions. WHITE, *supra* note 189, at 225-29. He seems to envisage an accounting system that would have sufficient strength to withstand short-run political and regulatory incentives to change it. "By making insolvencies more transparent, market value accounting would make politicians' and regulators' efforts to delay closure more difficult, or at least require them to offer better explanations to justify their actions." WHITE, *supra* note 189, at 229.

<sup>192</sup> FASB 107, *supra* note 187. Just in time to meet Chairman Breeden's deadline. See *supra* note 187. FASB 107 has now been extended by FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO.119, DISCLOSURE ABOUT DERIVATIVE FINANCIAL INSTRUMENTS AND FAIR VALUE OF FINANCIAL INSTRUMENTS (1994).

<sup>193</sup> FASB reluctantly adopted the term "fair value" because not all the valuations required are based on market prices:

held by the firm or issued by the firm, whether or not they are traded or even transferable. Financial instruments for which market prices are available are to be valued at market price. FASB 107 further provided that

If quoted market prices are not available, management's best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models, or matrix pricing models).<sup>194</sup>

"Financial instruments" is defined broadly.<sup>195</sup> FASB 107 does not require that net changes in the value of the assets and liabilities that are financial instruments be reflected either in the balance sheet or income statement of the entity. Rather, FASB 107 requires a separate disclosure which can be made in the

---

Some respondents to the 1990 Exposure Draft suggested that use of the term *market value* did not reflect adequately the broad range of financial instruments covered by this Statement. Those respondents associate the term *market value* only with items that are traded on active secondary markets (such as exchange and dealer markets). As highlighted by the discussion in paragraph 19 of this Statement, the Board does not make that distinction. The term *market value*, as defined in paragraph 5 of the 1990 Exposure Draft, is applicable whether the market for an item is active or inactive, primary or secondary. The Board decided, however, to use the term *fair value* in this Statement to avoid further confusion and also to be consistent with the terminology used in similar disclosure proposals made recently by other national and international standard-setting organizations. The concept of fair value is the same as that of market value in the 1990 Exposure Draft; those who associate the term market value only with items that are traded in active secondary markets may however prefer to consider fair value as a broader concept that includes prices and rates obtained from both secondary and primary markets.

FASB 107, *supra* note 187, at 37.

<sup>194</sup> FASB 107, *supra* note 187, at 5.

<sup>195</sup> A financial instrument is defined as

cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity

b. Conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

FASB 107, *supra* note 187, at ¶ 3 (footnotes omitted).

notes to the financial statements.

The FASB confronted the problem of what impact changes in the net value of the assets and liabilities reported at fair value should have on the income statement and balance sheet in FASB 115, issued in May 1993.<sup>196</sup> The answer: equity and debt securities (a much smaller universe than the "financial instruments" of FASB 107) should be valued at market on the asset side of the balance sheet if they are available for sale. The changes in their value, however, should not flow through to the income statement, but rather to a special subaccount in the shareholder's equity section of the balance sheet.<sup>197</sup> Equity and debt securities held to maturity would continue to be carried at cost. A large part of FASB 115 is designed to define strictly the "held-to-maturity" category and to limit the reasons for which securities can be reclassified,<sup>198</sup> with the purpose of

---

<sup>196</sup> FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 115, ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, (1993) [hereinafter "FASB 115"]. At the same time FASB issued FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 114, ACCOUNTING BY CREDITORS FOR IMPAIRMENT OF A LOAN (1993) [hereinafter "FASB 114"]. FASB 114 rejected any requirement that impaired loans be valued at fair value. It did, however, permit market valuation to be used as "as a practical expedient." *Id.* at ¶ 13. Two members (Leisenring and Swieringa) of the Board dissented from FASB 114 on the ground that it did not use the fair value approach. Two members (Sampson and Swieringa) dissented from FASB 115 for similar reasons.

<sup>197</sup> Thus avoiding the heated complaints of the banking industry that fair-value accounting would lead to misleading and harmful volatility in bank income (although, of course, there still is an impact on the volatility of equity capital). Banks also complained that fair-value accounting only for assets would fail to take into account the extent to which asset risks were offset by the issuer through the use of appropriately matched liabilities. The FASB said that it "believe[d] it would be preferable to permit certain related liabilities to be reported at fair value," but the FASB was unable to develop a workable approach. FASB 115, *supra* note 196, at 21 ¶ 51. Although FASB 115 applies to all for-profit entities, its biggest impact is on financial institutions, which tend to hold a large percentage of their assets in the form of debt securities. Lawrence White answers the concerns about the volatility introduced by market value accounting as follows: "But over time, managers would restructure those portfolios and adopt hedging and smoothing strategies; in the interim, the regulators need to know about those market value fluctuations (not all of which may be cyclical)." WHITE, *supra* note 189, at 228. Those "hedging and smoothing strategies" will themselves have costs and create risks.

<sup>198</sup> FASB 115, *supra* note 196, at 3-4, ¶¶ 7-11. It is notable that FASB 114 and FASB 115 would not have affected either the income statements or the balance sheets of the savings and loans during the 1970s, since their mortgage assets were not impaired (because principal and interest were paid on time), their mortgages were not securities (defined in FASB 115 as being obligations evidenced by a



ensuring that the "held-to-maturity" category not undermine the objective of requiring issuers to account for equity and debt securities on a mark-to-market basis.

#### *F. Identity of Investment Company (Mutual Fund) Managers*

A simple idea for reform of mutual-fund disclosures is that mutual funds should identify the person or persons who currently are making decisions about what securities the fund will buy or sell. The traditional mutual fund disclosure has focused on the results of its past investment activities, but an investor wants to know who has been (and is now) making the decisions. He or she is looking for someone who appears to have the ability to make good decisions in the future. Past successful results have no relevance if a different person is now making the investment decisions. Most mutual funds have been promoted without disclosure of who that person is. Why shouldn't the SEC require disclosure of the identities of the responsible decisionmaking people? After all, they are of greater importance to a mutual-fund investor than the identities of the board of directors, all of whose identities must be disclosed.

It has taken the SEC twenty years to implement this reform. Even though proposals to amend the disclosure forms to require such disclosure were made in 1972,<sup>199</sup> 1982<sup>200</sup> and 1984,<sup>201</sup> not until 1993 was the requirement adopted.<sup>202</sup>

The proposal finally adopted was proposed in 1989. It was

---

transferable instrument or a book entry for which the issuer maintains a transfer facility, FASB 115, *supra* note 196, at ¶ 137), and in any case they were held-to-maturity assets. FASB 107, *supra* note 187, however, would have required disclosure of the fair values in the notes to the financial statement.

<sup>199</sup> Proposed Guideline for the Preparation of Forms S-4 and S-5 Relating to Prospectus Disclosure of a Management Investment Company's Investment Adviser, its Organization and Personnel, Securities Act Release No. 33-5258, 1972 WL 17489 (SEC) (June 9, 1972).

<sup>200</sup> Registration Form Used By Open-End Management Investment Companies; Proposed Guidelines, Securities Act Release No. 33-6447, 1982 WL 35957 (SEC) (Dec. 27, 1982).

<sup>201</sup> Semi-Annual Report Form for Registered Investment Companies, Exchange Act Release No. 34-21208, 1984 WL 52029 (SEC) (Aug. 6, 1984).

<sup>202</sup> Registration Form for Closed-end Management Investment Companies (Adoption), Securities Act Release No. 33-6967, 1992 WL 348440 (SEC) (Nov. 20, 1992); [hereinafter "Release 6967"]; Disclosure of Mutual Fund Performance and Portfolio Managers, Securities Act Release No. 33-6988, 1993 WL 101994 (SEC) (April 6, 1993).

one of a number of initiatives whose objective was to make mutual-fund disclosure documents more relevant to the investor's decisionmaking process.<sup>203</sup> The new item requires mutual funds to

[d]isclose the name and title of all persons who make or are expected to make significant contributions to the investment advice provided to the Registrant and describe each person's business experience and the length of time he or she had been employed by or associated with the investment adviser (or Registrant).<sup>204</sup>

The rationale for the new item was explained by the Commission as follows:

The disclosure of this information is intended to make investors aware of the individuals who . . . may have a significant impact on the fund's investment success. This disclosure will permit investors to assess the background and experience of such person and evaluate the extent of this person's responsibility for the previous investment success (or lack thereof) of the fund before making an investment decision.<sup>205</sup>

The industry opposed this proposal, as it had its predecessors.<sup>206</sup> The Commission reported:

Investment company commenters expressed two principal concerns about the proposed item. First, they asserted that requiring information about persons who make "significant contributions" to the investment advice received by the fund could require disclosure about numerous professionals, e.g., analysts and traders, who participate in providing advisory services. This type of disclosure would significantly lengthen the prospectus and impose unnecessary costs on funds and their shareholders. Second, several commenters were concerned that the proposal would be difficult to comply with in the context of advisory organizations that incorporate team, committee or multi-manager structures.<sup>207</sup>

---

<sup>203</sup> Registration Form For Closed-end Management Investment Companies, Securities Act Release No. 6842, 1989 WL 257682 (SEC) (July 28, 1989) [hereinafter "Release 6842"]. Other notable changes relate to a MD&A section in which management is to disclose its investment strategies, a requirement that funds compare their past results with an index, and a requirement that closed-end funds disclose that closed-end funds often trade at a discount to their net asset value.

<sup>204</sup> Release 6842, *supra* note 203, at 56.

<sup>205</sup> Release 6842, *supra* note 203, at 14.

<sup>206</sup> Dean Foust, *Mutual Fund Show and Tell*, BUS. WK., June 28, 1993, at 130, reported that "[C]ompanies have been loath to identify—much less promote—the movers behind the funds."

<sup>207</sup> Release 6967, *supra* note 202, at 7.

In response to these objections, the Commission simplified the proposal to require the disclosure only of those who are "primarily responsible for the day-to-day management of the fund's portfolio."<sup>208</sup>

### G. *A Look at the Future*

These six foregoing examples are offered to show that accuracy enhancement is not just a plausible normative objective for disclosure regulation, but that its influence can be seen in regulatory actions taken and cases decided. Donald C. Langevoort, in an article in the *Harvard Law Review*, has taken the concept of accuracy enhancement one step further. His project, in an article entitled *Information Technology and the Structure of Securities Regulation*,<sup>209</sup> was to envision the impact that information technology will have on securities regulation. Drawing upon the legal-policy literature, he identifies disclosure practices as one area that should change.<sup>210</sup>

---

<sup>208</sup> Release 6967, *supra* note 202, at 41 (Item 9.1.c of Form N-2). The same requirement was adopted for open-end investment companies in Disclosure of Mutual Fund Performance and Portfolio Managers, Securities Act Release No. 33-6988, at 13, 1993 WL 101994 (SEC) (April 6, 1993) (Item 5(c) of Form N-1A). The requirements for open-end investment companies were proposed in Disclosure and Analysis of Mutual Fund Performance Information; Portfolio Manager Disclosure, Securities Act Release No. 33-6850, 1990 WL 309771 (SEC) (Jan. 8, 1990).

<sup>209</sup> Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747 (1985).

<sup>210</sup> Another article in the visionary (if not apocalyptic) mode is by Robert Mednick, a partner in Arthur Andersen & Co., and chairman of its worldwide committee on professional standards. Robert Mednick, *Reinventing the Audit*, J. OF ACCT., August 1991, at 71. Mednick says:

The accounting profession desperately needs a process for completely reengineering the audit function and regaining the public's confidence. . . . I believe CPAs can, by virtue of the training, history and orientation, best serve society as the premier suppliers of worthwhile information to managements, boards of directors and stakeholder groups. With the explosion of affordable information in recent years, a significant premium has been placed on the work of those professionals who can analyze, organize, validate and present information in useful and timely ways. . . . I believe investors and others want and expect more: more predictive and value-based information; more of the whys—not simply whats—of financial data; and more early warning that a company is making poor decisions or may be nearing the brink of financial collapse.

*Id.* at 71-74. A similar statement comes from KPMG Peat Marwick.

The U.S. financial accounting model . . . is broken and needs to be fixed.

The present practice of discrete, periodic paper filings can easily be replaced by a system of continuous electronic filing in which issuers transmit, in nearly real time,<sup>211</sup> all material information to the markets. According to Langevoort:

Implementation of such a system could lead to an even more significant policy change: the imposition on issuers of a genuinely continuous duty to update, one that would require virtually immediate disclosure of any highly significant investment information . . . .

For information to be valuable, however, it must be current. The purpose of the disclosure system is to give investors relevant data on which to base decisions to buy or sell. That purpose is not served when the profile of the company made available to investors has become outdated as a result of new developments. Under a paper-based filing system, practical concerns may justify a reluctance to impose an obligation to update information continually. But once an on-line database is established, furnishing issuers with instantaneous access to the file, investors should be able to expect the material in the file to be both current and complete.

Even without an updating requirement, many issuers would use the system voluntarily in order to correct and amend their files. In short, the electronic file would be a useful vehicle for instantly communicating to investors information that the company wants disclosed, in a manner that avoids questions of selective dissemination or illegal tipping. Mandatory updating is needed, however, to ensure that all material information is incorporated into the file in a

---

Its periodic, historical, cost-based financial statements served the bygone industrial era well but are not sufficient for evaluating information-era companies. . . . Today's periodic, historical, cost-basis financial statements do not provide as complete a set of relevant entity-specific data as is feasible to enable potential investors to understand the economic risk of investing; this undermines the spirit of management's discharge of its fiduciary responsibilities to shareholders.

Robert K. Elliott & Peter D. Jacobson, *U.S. Accounting: A National Emergency*, J. OF ACCT., November 1991, at 54-56.

Some of the legal policy literature relied upon by Langevoort is abstracted at the outset of this article, which uses the efficient markets arguments to support normative conclusions about securities regulation.

<sup>211</sup> Langevoort realizes that the disclosure cannot for practical reasons be immediate.

An issuer must have enough time to frame the disclosure in language that will not create misleading impressions. A useful presumption might be that material information must be placed in the system within one business day of a determination of materiality. That time period could be shortened or extended depending on such factors as the significance of the information, the size of the issuer, and the difficulty of accurately formulating the disclosure statement.

Langevoort, *supra* note 209, at 791.

timely fashion.<sup>212</sup>

## II. THE FLAWS OF ACCURACY ENHANCEMENT AS THE SINGLE GOAL OF SECURITIES DISCLOSURE

The first section of this Article set out the argument for accuracy enhancement as a normative goal for securities disclosure and gave examples of the importance of the idea in the context of specific regulatory and legal issues. In fact, however, the disclosure system does not require issuers to disclose all "information materially important to investors."<sup>213</sup> If an investor concludes that an issuer's securities disclosures really have provided an "opportunity to look at the company through the eyes of management" then the investor may be well advised to short the stock, because the perspective of management is complacent and self-satisfied and ignores the hostile and unpredictable world.<sup>214</sup> Even the disclosure regulations

---

<sup>212</sup> Langevoort, *supra* note 209, at 786-88. Interestingly, Langevoort concludes that his proposal would actually decrease the amount of information that issuers would provide. This is because he would remove the requirement for filing all of the fluff currently found in the forms. Issuers would electronically file only material information, and he would be willing to require only the filing of material adverse information. Langevoort, *supra* note 209, at 789. Langevoort also recognizes the existence of a business confidentiality problem. See *infra* note 230.

<sup>213</sup> H.R. REP. NO. 1383, *supra* note 2. The "all" is not in the original quote. Langevoort, *supra* note 211, at 786 describes the disclosure requirement as "the basic requirement that issuers disclose all material information relevant to their risk/return characteristics." Even more expansive is Comizio, who describes the disclosure obligation as one that requires issuers "to publicly disclose all material corporate information, financial and otherwise, in order to provide full and fair disclosure of the character of securities sold in interstate commerce." V. Gerard Comizio, *Keeping Corporate Information Secret: Confidential Treatment Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 18 NEW ENG. L. REV. 787, 787 (1983). And see 2 LOSS & SELIGMAN, *supra* note 4, at 27: "Then, too, there is the recurrent theme throughout these statutes of disclosure, again disclosure, and still more disclosure. Substantive regulation has its limits. But 'The truth shall make you free.'"

The rejection of the proposition that "a corporation has an affirmative duty to disclose all material information even if there is no insider trading, no statute or regulation requiring disclosure, and no inaccurate, incomplete, or misleading prior disclosures" and the assertion that "[t]he prevailing view . . . is that there is no such affirmative duty of disclosure" in cases such as *Backman v. Polaroid Corp.*, 910 F.2d 10, 12 (1st Cir. 1990) (en banc), *quoted in and followed by* *Glazer v. Formica Corp.*, 964 F.2d 149, 157 (2d Cir. 1992), does not address the question of what the statute and the implementing SEC regulations in fact require.

<sup>214</sup> As Homer Kripke reported: "Since 1967, I have tried with my classes to see

themselves provide for nondisclosure in the event of competitive harm in a few isolated instances.<sup>215</sup>

---

what could be learned about a company from a prospectus which we studied together intending to make a securities decision from it. I have realized how the SEC's mandated disclosure fails to accomplish its avowed purpose." KRIPKE, *supra* note 6, at 274. "The prospectus is a somewhat schizophrenic document, having two purposes which often present conflicting pulls. On the one hand, it is a selling document. . . . From this point of view, it is desirable to present the best possible image. On the other hand, the prospectus is a disclosure document, an insurance policy against liability. With the view toward protection against liability, there is a tendency to resolve all doubts against the company and to make things look as bleak as possible." Carl W. Schneider, et al., *Going Public: Practice, Procedure and Consequences*, 27 VILL. L. REV. 1, 14 (1981). The popular business press has recently discovered that much important information is omitted from securities disclosure documents. See Barry Vinocur, *The Ground Floor: Some Potential Investors Fault Disclosure As Office REIT Barrage Continues*, BARRON'S, May 2, 1994 at 50 (Office REIT IPO's fail to disclose the inevitable fall in office rents as leases come up for renewal); Kurt Eichenwald, *Market Place: At a Rail Car Maker, Lawsuits Test the Importance of Being Earnest*, N.Y. TIMES, Aug. 11, 1993, at D6 c.3 (Prospectus of Johnstown America Industries, Inc. failed to mention pending patent infringement case against key competitor; patent covers important product); William Power, *Heard on the Street, In IPOs, Some Data Seem to be Overlooked by Issuers as in Case of Santa Cruz Operation*, WALL ST. J., July 27, 1993, at C2 (Chairman of Santa Cruz Operation dies after an initial public offering, his illness undisclosed; sexual harassment lawsuit also undisclosed). As to mutual funds, see James B. Stewart & James J. Cramer, *The Secret Society: Why Don't Mutual Funds Do a Better Job of Providing You with Information about your Investments? The Answer Is Simple: They Don't Want To*, SMART MONEY, Nov. 1994, at 98, 100. An unusually candid, detailed and readable account which reveals the discontinuity between the marketing of the initial public offering of Vertex Pharmaceuticals, Inc. in July 1991 and business reality is BARRY WERTH, *THE BILLION DOLLAR MOLECULE: ONE COMPANY'S QUEST FOR THE PERFECT DRUG* (1994). The only professionals who displayed embarrassment were the scientists. "The scientists, understandably, saw another view. They saw unproven science, unmet expectations, uncertain goals—a story lunging out of touch with reality." *Id.* at 351. Vertex went public at 9, traded at a high of 20 in January 1994, and as of December 1994 traded at 11 1/2. Because Vertex never traded below its offering price, there was no occasion for a Securities Act lawsuit. Readers who are skeptical of the characterizations in the text are invited to read a few prospectuses and try to decide whether or not they wish to invest in the issuer based on what is disclosed about the issuer's business. Annual reports (although not prospectuses which, due to the wider net of Securities Act liability are written by the lawyers, nor quarterly reports, which are too short) do in some cases provide evidence that the management has an active intelligence. Warren Buffett's annual reports written as Chairman of Berkshire Hathaway are famous for actually saying something.

<sup>215</sup> See Item 101(c)(ii) of Regulation S-K, 17 C.F.R. § 229.101(c)(ii)(1995) (a description of a product or segment that would require the investment of a material amount of the assets of the registrant or that otherwise is material and has been publicly announced) ("This paragraph is not intended to require disclosure of otherwise non-public corporate information the disclosure of which would affect adversely the registrant's competitive position."); Item 402(e), Instruction 2, 17 C.F.R.

In spite of the fact that the securities laws require disclosure of only a small part of all material corporate information, there is no explanation in the tradition of the securities laws to explain why this should be the case. Questions remain as to whether the present disclosure requirements are simply naive and defectively implemented, or whether they in fact reflect important but unarticulated considerations.

Analysis reveals that the present disclosure practices do reflect important considerations. The first consideration is the risk of liability created by the securities laws themselves, a risk that makes the disclosure more costly the more likely it is to be relevant to, and therefore affect, the market price of securities. The second consideration is the need for issuer secrecy in an environment where information in the hands of third parties, particularly competitors, can be used to harm the issuer.

#### A. *Liability Risk*

The securities laws impose a risk of liability on anyone who makes a statement relevant to the market price of a security. Disappointed security holders who buy or sell after the statement may sue on the grounds that the statement was misleading or incomplete, thereby causing their loss. One way for issuers to respond to this risk is to reduce the number of statements they make, and the definiteness of those they do make. Issuers are likely to respond in this way as their ability to predict whether any given statement will lead to litigation or liability decreases. Their difficulty in prediction may result from their own inability to determine whether the statement is misleading or incomplete, their inability to predict when litigation will occur, or their inability to predict the outcome of litigation when it does occur. Saying less means litigating less and being held liable less often. Liability is a cost of the activi-

---

§ 229.402(e)(1995) (relating to disclosure of long term incentive plans) ("Registrants are not required to disclose any factor, criterion or performance-related or other condition to payout or maturation of a particular award that involves confidential commercial or business information, disclosure of which would adversely affect the registrant's competitive position."). It is odd that the Commission has singled out these two items for an express competitive harm exception from the disclosure obligation.

ty of making statements, and will reduce the level of that activity.<sup>216</sup>

The impact of the risk of liability on the cost of the production of information is an example of the problem of over-deterrence by the legal system. Liability rules can affect the overall level of an activity—in this case the production of information—in ways that are socially harmful. It is of particular concern in the securities area for two reasons: first, because the losses suffered by parties who trade after information that turns out to be misleading is released can be large and easily quantified; and second, because much “information” is produced as the result of an estimating process, and may or may not turn out to be correct. An important virtue of the traditional, historic fact-based disclosure system is that it required the production of discrete facts that can be identified, verified, recorded, retrieved and reported by nonmanagement personnel—for example, the reported, audited gross revenues for the last fiscal year, or the name of the chief executive officer. The required disclosures involved no representation, implicit or otherwise, that the disclosures were relevant to the value of the firm, much less the market price of its securities.

The same cannot be said of “known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact.”<sup>217</sup> When is a trend “known,” and by whom? When does a series of numbers become a trend?<sup>218</sup> Does management not only have to

---

<sup>216</sup> Easterbrook and Fischel used this insight in their analysis of optimal damages in securities cases.

It is easy to see that there may be an “optimal level of breach” in ordinary contracts. It is not so obvious that this is so with securities contracts. Nevertheless, the same principles apply. “Truth,” like all good things, is costly to produce. The person selling securities must investigate the business venture at hand and package the information in a form that investors can understand. The process of acquiring and packaging information can be exceptionally expensive. Whole industries—accounting, investment banking, much of the bar, much of the financial press—are the embodiments of the costs of investigation and certification of information about firms and their securities. For any complex business, it is impossible to find and present “everything material” in a space less than that of a decent-sized library.

Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 613 (1985).

<sup>217</sup> 17 C.F.R. 229.303(a)(3)(ii)(1995).

<sup>218</sup> The beguiling notion that one can profit by identifying and then investing in



work at acquiring and analyzing information and deciding on appropriate business responses, but also continuously participate in the collection and analysis leading to the filing of disclosure documents, which must contain those trends that management has determined it knows, and reasonably expects, will have a material favorable or unfavorable impact? Where and when did the Caterpillar corporation get it wrong?

For example, suppose the company has an old product whose sales have been declining for years. The trend in sales is clearly known, and expected. The product, because all its development costs have been amortized and the company has gotten very good at making it efficiently, enjoys a high profit margin and makes a significant contribution to the company's earnings. This might seem to be a clear indication that the company's earnings will fall except for the fact that the company has developed and introduced newer products whose sales are rising, although the profit margins are not as high. The company hopes that the new products will eventually take the place of the old product line, and that the company's net profits will continue to rise. Does the company need to disclose and reveal the decline in sales of the old product? Who decides, and how? The decline is a known trend, and because of the high profit margin the trend will have a material unfavorable impact on earnings. How much detail does the issuer have to give? Can it say: "during the year, declining sales of older product lines were offset by increasing sales of new product lines"? Whatever the answer to these questions, does the company have any assurance that, whatever it says, it will be able to establish in subsequent litigation that that was what it should have said, particularly if the litigation occurs (as it probably will, if at all) in the aftermath of a distinctive move in the price of its stock?

It is ironic that in the past SEC Chairmen have so easily recommended aspects of English disclosure practice without pausing to wonder whether those practices don't depend on the lack of meaningful exposure to civil liability in the English

---

a trend lies behind charting methodology, whose usefulness has never been proven. Although in retrospect a series of numbers will evidence clear trend patterns, that does not mean that a presently known series contains information about the future.

system.<sup>219</sup> In the U.S. legal culture, the insight that the production of information can be deterred undesirably by excessive risk of liability has been treated as persuasive in the area of the constitutional protection of freedom of speech. The Supreme Court said in *New York Times v. Sullivan*:<sup>220</sup>

Allowance of the defense of truth with the burden of proving it on the defendant, does not mean that only false speech will be deterred . . . under such a rule, would-be critics of official conduct may be deterred from voicing their criticism, even though it is believed to be true and even though it is in fact true, because of doubt whether it can be proved in court or fear of the expense of having to do so. . . . The rule thus dampens the vigor and limits the variety of public debate. . . .<sup>221</sup>

---

<sup>219</sup> Chairman Cohen, endorsing British practice relating to segmentation, *supra* note 84, and Chairman Casey, endorsing British practice relating to forecasts, *supra* text accompanying note 44. Civil actions comparable to those available in the United States exist in other countries, but as a result of procedural and cultural barriers such litigation rarely occurs. See NORMAN S. POSER, *INTERNATIONAL SECURITIES REGULATION*, §§ 3.7.6.1, 3.7.6.2, at 293 (1991).

[T]he American rule with respect to the awarding of attorneys' fees, and the greater ease of bringing derivative suits and class actions all militate in favor of bringing investors' suits in the United States. In these respects, an American firm is far more exposed to liability in civil suits than a British firm, although this may change as investors, lawyers, and judges gain more experience under the new U.K. regulatory system.

*Id.* §3.7.6.2 at 300-01.

Change, unrelated to the Financial Services Act which Poser discusses, may be indicated by the recent success of the "names" at Lloyd's, whose lawsuits resemble an American class action securities case. The Lloyd's names, who invested in unlimited liability insurance syndicates on the Lloyd's exchange, face not only the loss of their investment but substantial additional liability. This threat so motivated some of them that they were able to overcome the barriers to successfully litigating their claims in the U.K. courts. Compare Robert Rice, *Lloyd's Ball Bounces in the Solicitors' Court: A Look at the Complex Collection of Cases Being Prepared on Behalf of Anxious Names*, FIN. TIMES, March 3, 1992, at 12 ("Many lawyers in the City feel that Mr Freeman's action is unlikely to do more than delay the inevitable—but this may not matter") with Jim Kelly & Ralph Atkins, *The Gooda Walker Judgment: Jubilant Names Hail 'Justice and Salvation'*, FIN. TIMES, Oct. 5, 1994, at 8 and Richard Lapper, *The Gooda Walker Judgment: Group Led by Cool Chairman*, FIN. TIMES, Oct. 5, 1994, at 8. The names had to proceed as a collection of individuals and work out cost sharing among themselves in the absence of an available class action device. The group of names who invested in the Gooda Walker syndicate won a favorable judgment based on a theory of mismanagement from the British High Court on October 4, 1994. Ralph Atkins & John Mason, *Lloyd's Names Win Battle Against Gooda Agency: Court Ruling Gives 3,000 Members Prospect of Record Pounds 504m Compensation*, FIN. TIMES, Oct. 5, 1994, at 1.

<sup>220</sup> 376 U.S. 254 (1964).

<sup>221</sup> *Id.* at 279. See also Frederick Schauer, *Fear, Risk and the First Amendment*:

Concern about over-deterrence has not been entirely absent from the culture of U.S. securities regulation.<sup>222</sup> Indeed, one could imagine recasting the literalist interpretive style of *Ernst & Ernst v. Hochfelder* into the *New York Times* case of securities regulation. Just as *New York Times* imposed a requirement that the plaintiff prove actual malice, *Hochfelder* imposed a requirement that the plaintiff prove scienter. And the SEC itself has recognized, most recently in its 1994 Concept Release: *Safe Harbor For Forward Looking Statements*,<sup>223</sup> that the threat of liability has something to do with the reluctance of issuers to provide information. Yet it is striking how seldom concerns about over-deterrence are even voiced in the legal culture of securities regulation. For instance in the *Basic* case the defendants asserted in their reply brief only that, "[a]ny other standard [than the agreement in principle standard of materiality] would impose sanctions on corporate managements which, with salutary motives, choose to speak, whereas, if they had chosen to remain silent under identical conditions, they would not be subject to claims for damages."<sup>224</sup>

This single sentence was then bolstered with a quote from Judge Henry Friendly, concurring in *Texas Gulf Sulphur*:

If the only choices open to a corporation are either to remain silent and let false rumors do their work, or to make a communication, not legally required, at the risk that slip of the pen or failure properly to amass or weigh the facts—all judged in the bright gleam of hindsight—will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers, most corporations would opt for the former.<sup>225</sup>

---

*Unraveling the "Chilling Effect,"* 58 B.U. L. REV. 685, 705-711 (1985); Daniel A. Farber, *Free Speech Without Romance: Public Choice and the First Amendment*, 105 HARV. L. REV. 554 (1991).

<sup>222</sup> For instance Brudney, *supra* note 165, at 733 n.31, is sensitive to this problem: "Another source of injury to the corporation from disclosure is the possibility that the disclosure is more or less innocently inaccurate, and especially if the corporation's proffered soft information turns out to be unfulfilled and exposes the enterprise to litigation and potential liability in the light of hindsight." See also sources cited *infra* note 230.

<sup>223</sup> 1994 Concept Release, *supra* note 77.

<sup>224</sup> Reply Brief of Respondents at 6, No. 86-279 *Basic v. Levinson*, 485 U.S. 224 (1988).

<sup>225</sup> *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly,

In the aftermath of *Basic*, the phrase, "[n]o comment" has become the mantra of issuers who are asked about merger negotiations.

The problem of over-deterrence is increased by the logic of materiality. Materiality is judged (under the Rule 408 standard) by whether or not the information is necessary "to make the . . . statements, in the light of the circumstances under which they are made, not misleading." The more that is disclosed, the more that becomes material, the more that must be disclosed, and so on, which can only be escaped by not disclosing much in the first place.<sup>226</sup> Suppose, for instance, that one is preparing a disclosure document about a biotech start-up company. One comes to the management section, surely one of the most important areas of interest to an intelligent investor. Who are the people who will be making the key decisions about this company, and what reasons are there to think that their decisions will be profitable? One looks at the form, and finds that it requires the disclosure of the names and ages of all executive officers, and their business experience during the last five years. But gee, that sounds pretty dull. Wouldn't it be a good idea to mention that the Vice President for Research already holds patents for several important inventions and was described at a dinner in his honor last year "as the leading intellect in his field?" And what about the President? What about the fabulous job he did turning around the Zeta Corporation seven years ago, and the fact that he is man of enormous energy, who sleeps only four hours a night, and was mentioned in *Fortune Magazine* as "a business genius." But if we provide information about the officers other than the details required by the forms, do we need to provide such information about every officer? How about the Treasurer, who was fired from his

---

J., concurring), *cert. denied*, 394 U.S. 976 (1968).

<sup>226</sup> This is the principal reason why in the aftermath of *Basic*, issuers prefer not commenting to saying something of substance. This effect of materiality doctrine operates both within the framework of the disclosure regulations and in relation to whether an issuer should say anything at all. A recent example of this logic at work in the latter context is *In re Time Warner Inc. Securities Litigation*, 9 F.3d 259 (2d Cir. 1993), *cert. denied*, 114 S. Ct. 1397 (1994), where the Second Circuit held that statements by Time-Warner that it was seeking additional financing through "strategic partnerships" created an obligation to subsequently disclose that it was considering a rights offering.

job at another company three years ago? And gee, the Vice President for Manufacturing sometimes sneaks in late. And, well, why don't we drop the whole thing?

### B. *The Issuer Interest in Secrecy*

Secrecy is difficult to document.<sup>227</sup> The most effective strategy for preserving secrets is to conceal their existence from those who could benefit from learning about them. One does not keep a secret, as children quickly learn, by saying: "I have a really important secret that you would like to know but I won't tell you." The thesis here depends upon the proposition that issuers have important secrets that they successfully conceal, and therefore there is no proof of their existence.

In Congressional testimony in 1934, the New Deal brain truster Thomas Corcoran asserted that there is no important secrecy in business. Corcoran stated:

Parenthetically, every one who has ever dealt with industrial engineers knows that the system of commercial espionage that exists at the present time in the United States is so perfect that normally the directors of a corporation know much more about their competitors' business than they do even about their own; that any competent engineer for a manufacturing concern, for example, who knows the location of that plant, the prevailing rate of wages for labor, the cost of raw materials, railroad rates to the nearest market and other costs of transportation, all now on almost a uniform basis, can, according to one of the best engineers I know who [I] sat with the other night, compute the cost of production and the cost of selling of any competitor's product down to 1¼ percent.<sup>228</sup>

The argument that there are no secrets in business echoes down through the history of discussions about disclosure. Of course, if all managements already know everything about their competitors, it is hard to understand why some are able to operate their businesses more profitably than others. The most important defect in this line of argument is that it is

---

<sup>227</sup> As I first became aware doing research for Edmund W. Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. OF LEGAL STUD. 683 (1980).

<sup>228</sup> *Stock Exchange Practices, Part 15: National Securities Exchange Act 1934, Hearings on S. Res. 84, 72d Cong. & S. Res. 56 & S. Res. 97, 73d Cong., Before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. 6533 (1934), reprinted in 6 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J.S. Ellenberger & Ellen Mahar eds., 1973).*

based on a simple binary model of knowledge: either competitors know or they do not. In fact, of course, firms know and should know a lot about their competitors. Furthermore, in many cases, firms want their competitors to believe certain things about them, things that may or may not be entirely true. But most of what firms know about their competitors is what their competitors did yesterday, not what they plan to be doing tomorrow. Tommy Corcoran's friend, the engineer, may have been overconfident about his knowledge—perhaps the firm, unbeknownst to him, had changed and improved its production technology, reducing its costs. And everything firms know about their competitors that is relevant to competition is known with differing degrees of certainty. Required securities disclosures, when put together with information from other sources, can change the degree of certainty attached to what one "knows."

Further complicating any effort to evaluate the importance of secrecy objectively is the reality that often the best strategy for protecting information is to protect all information, or at least to protect that which would suggest the existence of important secret information. It is difficult visibly to expend resources to protect information without giving away the fact that the information is important, and thereby increase the incentives for others to invest in acquiring it. One defense against this is simply to protect all information.

Finally, although the arena in which secrecy is most important for businesses is the competitive one, disclosure can also cause harm to the corporation from third parties. For example, one significant risk from financial disclosure is that it will lead to tax liabilities. When profits are reported for financial disclosure purposes, taxes may follow.<sup>229</sup>

---

<sup>229</sup> The Internal Revenue Code § 446(a), 26 U.S.C. § 446(a)(1994), provides "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Thus a system of accounting used for financial reporting can affect tax issues. See *Comm'r of Internal Revenue Service v. Idaho Power Co.*, 418 U.S. 1 (1974):

Although agency-imposed compulsory accounting practices do not necessarily dictate tax consequences, they are not irrelevant and may be accorded some significance. The opinions in *American Automobile Ass'n v. United States*, 367 U.S. 687 (1961), and *Schlude v. Commissioner of Internal Revenue*, 372 U.S. 128 (1963), urged upon us by the taxpayer here, are not to the contrary. In the former case it was observed that merely

## 1. The Argument

The problem with accuracy enhancement as the normative goal for securities disclosure is that the very information that will enable investors to value the corporation is information that can and will be used by competitors and others to decrease the value of the issuer. Investors can have the information, but at a price: their investment will be worth less. This is a point that many sophisticated commentators have made; the

---

because the method of accounting a taxpayer employs is in accordance with generally accepted accounting procedures, this "is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury." 367 U.S. at 693. . . . Nonetheless, where a taxpayer's generally accepted method of accounting is made compulsory by the regulatory agency and that method clearly reflects income, it is almost presumptively controlling of federal income tax consequences.

*Id.* at 14-15 (citations omitted). See also *Mazzocchi Bus Co. v. Comm'r of Internal Revenue Service*, 14 F.3d 923 (3rd Cir. 1994). The link between financial reporting accounting and tax accounting was made explicit for three years under the alternative minimum tax passed as part of the Tax Reform Act of 1986. The Tax Reform Act of 1986 § 701(a), 100 Stat. 2085, 2326-2327, added a new § 56(f)(1) to the Code which added 50 percent of the amount by which the adjusted net book income of the corporation exceeded the alternative minimum taxable income for tax years beginning in 1987, 1988 and 1989 to the alternative minimum taxable income. Adjusted net book income was defined as "the net income or loss of the taxpayer set forth on the taxpayer's applicable financial statement, adjusted as provided in this paragraph." 26 U.S.C. § 56(f)(2)(A)(1988)(repealed 1990). The Senate Committee on Finance explained:

Tax fairness also requires that corporate taxpayers pay amounts of tax appropriate for their level of earnings. The committee finds it unjustifiable for some corporations to report large earnings and pay significant dividends to their shareholders, yet pay little or no taxes on that income to the government. The committee has designed a strong alternative minimum tax for corporations, based on a broad tax base, to prevent corporations from significantly reducing their tax liability. A unique feature of this alternative minimum tax is the inclusion of a corporation's book income in the tax base used for this computation.

S. Rep. No. 313, 99th Cong., 2d Sess. 6 (1986). The then expired provision was removed from the Internal Revenue Code in 1990. Omnibus Budget Reconciliation Act of 1990 § 11801(c)(2), 104 Stat. 1388-522 (Nov. 5, 1990) 26 U.S.C. § 56(g)(4)(c)(1994).

German accounting is creditor-and-tax driven. German taxes are based on the reported results. These earnings are smoothed from year-to-year, which provides a more even flow of revenue to the government. For instance, Daimler-Benz, which after its listing on the New York Stock Exchange reports both German and U.S. GAAP results, reported profits on a German accounting basis in a recession year, while reporting a loss on U.S. GAAP. See Barry Riley, *Prudence and Pragmatism in German Reporting*, FIN. TIMES, Sept. 28, 1994, at 27, available in WESTLAW, FTF Database.

analyst needs to be sensitive to the costs of disclosure, including the effects on an issuer's competitive position.<sup>229</sup> But the point is always made for analytic completeness, not to suggest that it is a real problem.<sup>231</sup> Indeed, concerns about harm to

---

<sup>229</sup> Langevoort devotes several sentences to this problem.

Under the electronic system, the disclosure rule should allow companies to withhold confidential information from the electronic file when the best interests of the corporate entity—that is, those of the shareholders as a group—outweigh the need for prompt disclosure. In such circumstances, the investing public has no legitimate expectation of disclosure. The privilege not to disclose, however, should be limited to prospective information about plans, proposals, negotiations, and the like that premature disclosure might thwart. Management should not be able to withhold material information simply because disclosure would embarrass or inflict some other sort of inchoate “harm” on the company. In order to strike a balance between these two legitimate interests, the electronic disclosure rule should require that a corporation disclose all material information unless it can show a significant risk of financial harm to its shareholders.

Langevoort, *supra* note 209, at 791. “A potential detriment is the possible, competitive injury to issuers making future-oriented disclosures, although the competitive gains achieved by access to the disclosures of others may ameliorate this injury.” Roger J. Dennis, *Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective*, 46 MD. L. REV. 1197, 1212 (1987).

More importantly, as we have seen, to require disclosure imposes costs upon the corporation and society if the disclosure is ‘premature’ or otherwise advantages competitors. Disclosure of a projection, asset appraisal, or other information whose import may be unassailable as a matter of logic, may properly not be required to be disclosed because of its costs to the corporation and its nontransacting stockholders.

Brudney, *supra* note 165, at 742-43 (footnotes omitted). The accountants recognize these costs in FASB CONCEPTS 1, *supra* note 1, ¶ 23 and somewhat oddly (given the subject of the statement) in FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS No. 2: QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION ¶¶ 137, 140 (1980) [hereinafter “FASB CONCEPTS 2”]. See also GEORGE J. BENSTON, CORPORATE FINANCIAL DISCLOSURE IN THE UK AND THE USA 142-43 (1976).

<sup>231</sup> It has not been a problem in securities regulation. This could be explained in two different ways. One, that issuer need for secrecy is not in fact a problem. The other, that issuer need for secrecy has not been a problem because the securities laws have not required the disclosure of information important enough to be kept secret. COX, ET AL., *supra* note 20, capture the received sense of its importance when they observe: “As *Basic* indicates, there will naturally be costs associated with a broad definition of materiality. At the extreme, some confidential information may be exposed.” COX, ET AL., *supra* note 20, at 75 (emphasis added). FASB CONCEPTS 2, *supra* note 230, ¶ 139, recognizes, but is somewhat dismissive of, competitive concerns:

From the point of view of society, the loss of competitive advantage that is said to result from some disclosure requirements is clearly in a different category from the other costs involved. Although the loss to one business enterprise may be the gain to another, the Board is aware of and



the issuer have become so attenuated in the culture of securities law that the need for secrecy is hardly ever used as an argument.<sup>232</sup> In the years before the rise of accuracy enhance-

---

concerned about the economic effects of the possible discouragement of initiative, innovation, and willingness to take risks if a reward to risk taking is denied. That is another cost that is impossible to begin to quantify.

<sup>232</sup> This is illustrated by the approach a securities lawyer takes to a problem involving disclosure of significant but unasserted claims that exist against the issuer. For example, Problem 2-1 in COX, ET AL., *supra* note 20, at 80, involves an issuer in the process of preparing a 10-K whose only plant has recently been discovered to encroach two feet onto adjoining property due to a surveying error made 20 years ago. If the owner of the adjoining property discovers the encroachment and asserts its rights, it will be necessary to close the plant to correct the encroachment, with a large financial loss. If the owner of the adjoining property does not discover the encroachment (which it has not for almost 20 years), the period of adverse possession will have run and the claim will be lost. Does the issuer have to disclose the encroachment in the 10-K, thus greatly increasing the likelihood that the claim will be asserted and the issuer will suffer loss? The answer turns out to be no, but the securities lawyer gets there not on the ground that disclosure harmful to the issuer is not required, but by a long and convoluted process that requires examination of all the items of required disclosure on 10-K, FASB 5 on contingent liabilities, and careful evaluation of the *Basic* standard of materiality. See William F. Bavinger & John T. Sant, *Disclosure of Unasserted Claims Under GAAP and the Securities Laws: Inviting Liability*, 6 INSIGHTS, September 1992, at 14. See also Problem 2-1 in TEACHER'S MANUAL for COX, ET AL., *supra* note 20, at 13.

Yet, why wouldn't the Court's reasonable investor consider the encroachment significant, and prefer to calculate for himself whether or not the right will be asserted? Of course, any reasonable stockholder would prefer that the encroachment not be disclosed, since then it might be asserted, but the Court's reasonable investor is unconcerned about cost.

The convoluted metaphysics of disclosure law creates a potential area of practice for outside counsel, since an issuer whose decision not to disclose has been reached after consultation with a securities lawyer can later argue the absence of scienter in an implied Rule 10b-5 action when it is sued after the bad (good) news comes out and the stock price falls (rises). See David S. Ruder, *Development of a Corporate Disclosure Compliance Program*, 6 INSIGHTS, June 1992, at 3 for an example of a leading academic securities lawyer (and ex-Commission Chairman) arguing the need for outside counsel:

A role may also exist for outside counsel. The law department may be well advised to maintain contact with outside counsel experienced in disclosure matters, so that it can consult regarding important or unusual problems that may arise. It also may be useful from time to time to ask outside counsel to review the corporation's disclosure practices and policies in order to determine whether improvements can be made.

*Id.* at 6. And: "For instance, a competent disclosure lawyer may help to interpret the materiality standards of [*Basic*]. . . . Experienced outside counsel may assist in reaching important judgments on materiality in the probability/magnitude context of this test." *Id.* at 6 n.8. The immunizing effect of a lawyer's opinion on 10b-5 liability is discussed in Bevis Longstreth, *Reliance on Advice of Counsel as a De-*

ment, the argument against expanding the scope of disclosure was either that it would result in the disclosure of too much information, which would overwhelm the investor, or that it would result in the disclosure of confusing information, whose uncertainties the investor would be unable to evaluate. Both are poor arguments<sup>233</sup> which no longer sound persuasive to the decisionmakers, but they do appear to have curbed (or at least justified curbing) the expansion of the disclosure obligation for years.<sup>234</sup>

---

*fense to Securities Law Violations*, 37 BUS. LAW. 1185 (1982). It is not so clear, however, what an experienced lawyer is actually willing to conclude about materiality:

The determination of "materiality" of a fact or its omission, or of whether there is a material inaccuracy in a statement, involves many questions of fact and judgment. Usually any legal judgment will be based on a factual analysis peculiarly within the knowledge and capability of the management of the issuer. Although a lawyer can be helpful in bringing his experience, interrogation techniques and judgment to bear on question of materiality, he cannot—and should not—take over from the issuer or other more qualified parties the responsibility for decision in these gray areas.

Association of the Bar of the City of New York, *Report by Special Committee on Lawyer's Role in Securities Transactions*, 32 BUS. LAW. 1879, 1895 (1977).

<sup>233</sup> The first, because the investor can use a table of contents to locate the information of interest, the second because an important part of the audience consists of professional analysts who are as prepared to use the information as anyone.

<sup>234</sup> In *Basic* the defendants did, atypically, make an argument based on harm to an issuer involved in merger negotiations. But they made it quietly. Petitioner's Reply Brief at 7, *Basic v. Levinson*, No. 86-279, 485 U.S. 224 (1988) ("There is sometimes a tension between the desire to keep investors informed and the attainment of results that are in the best interests of stockholders"). The principal thrust of the defendant's arguments was that they had not made a misrepresentation. The Court's response was brief: "[W]e think that creating an exception to a regulatory scheme founded on a prodisclosure legislative philosophy, because complying with the regulation might be 'bad for business,' is a role for Congress, not this Court." *Basic v. Levinson*, 485 U.S. 224, 239 n.17 (1988). The Court gives the argument some credence earlier in the opinion:

We need not ascertain, however, whether secrecy necessarily maximizes shareholder wealth . . . for this case does not concern the timing of a disclosure; . . . Arguments based on the premise that some disclosure would be "premature" in a sense are more properly considered under the rubric of an issuer's duty to disclose. The "secrecy" rationale is simply inapposite to the definition of materiality.

*Id.* at 235 (footnotes omitted). The Court does not explain why the "secrecy rationale" is "more properly considered under the rubric of an issuer's duty to disclose." The statutes make the duty to file a 10-K, 8-K, 10-Q or a registration statement for a public offering absolute, with no special timing or exemptive treatment based on the need for secrecy.

If concerns about the harm to issuers are in fact a substantial problem, as where competitive strategies rather than minor details are sought to be kept secret, then the objective of accuracy enhancement becomes highly problematic. It is impossible to provide disclosures that purport to reveal all material information relevant to the value of a business while permitting the omission of relevant information because of the need for secrecy. The investor cannot use the resulting document as an authoritative guide to the value of the issuer, since he cannot even determine what is omitted.

Lawyers form their judgment about the importance of secrecy for business from the legal system. The reported trade-secret cases involve technical information about production processes and information about the identity, location and needs of customers. The defendant in such cases is typically a low-level employee involved in production or dealing directly with customers who has left the plaintiff's employment to form or work for a competing business. Businesses do not sue departing high-level management employees because of their access to strategic and planning information about the business.<sup>235</sup> But the protection of secrecy through litigation is always problematic. It is difficult to sue claiming that a secret has been stolen without identifying the secret, at least to the defendant. The identity of the crucial information may be the most important secret of all.<sup>236</sup>

Another way to understand the role of secrecy is to develop a model of the functions management performs in order to

---

<sup>235</sup> In the summer of 1993 General Motors departed from this pattern when Vice President S. Ignacio Lopez de Arriortua left General Motors for Volkswagen, and General Motors pursued him with legal actions (including criminal investigations) on two continents. *Court Proposes GM-VW Settlement; New Probe Due*, WASH. POST, November 10, 1993, at F4; *GM: VW Ruining Germany's Image*, WARD'S AUTO WORLD, June 1, 1994, at 19. Procter & Gamble has recently been pursuing an aggressive litigation strategy against high-level management employees departing for Johnson & Johnson. Jennifer Kent, *Pepper Going to Court Over Trade Secrets; P&G Sues Ex-Workers Hired by Rival Company*, CINCINNATI POST, Sept. 23, 1994. That case has been settled. *P.G. Lawsuit Involving Trade Secrets Is Settled*, N.Y. TIMES, Oct. 4, 1994, at D4.

<sup>236</sup> The loyalty of high-level employees may be virtually assured by the level and structure of compensation packages. See Gary S. Becker & George J. Stigler, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, 3 J. LEG. STUD. 1 (1974); Gary S. Becker, *Investment in Human Capital: A Theoretical Analysis*, 70 J. POL. ECON. 9 (1970).

identify the type of information management needs to perform those functions, and then to determine whether it is important to the effective performance of the function that the information remain confidential. The legal literature focuses not on the positive functions of management but on the constraints which the law places on management.

Surely all would agree that a principal management function is the function of increasing the value of the business.<sup>237</sup> That function has important implications for disclosure policy. The reason that information about past results provides an incomplete basis for valuing a firm is that the important question is not what the past results were, but what management is going to do about the past results. Maybe a long string of poor results shows that management doesn't know what to do; or maybe a long string of poor results increases the likelihood that management will be forced to do, and will do, something. So is born the turnaround play. Conversely, a long string of good results is important only if management knows how to continue to get good results. If the purpose of disclosure is to enable investors to correctly value the stock of the issuer, the information they need is information about what steps management is taking, and is going to take, to improve or preserve the performance of the issuer. The investor can then evaluate those steps and decide for him or herself whether they are likely to work.

The problem is that if management has correctly identified the steps to take, once competitors learn what the steps are they can proceed to follow those steps. If, for instance, the key is to get out of one business which is losing money and has no prospect for improvement while expanding investment in another, which is more profitable and likely to grow, then once the issuer discloses these steps and the reasons why they are

---

<sup>237</sup> The ALI Principles of Corporate Governance provide that "a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain." AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01(a) (1992) [hereinafter "ALI PRINCIPLES OF CORPORATE GOVERNANCE"]. The Principles do not analyze, however, the nature of the environment which best enables the corporation to achieve that objective. The board of directors is assigned the power, but not the function, of managing the corporation. ALI PRINCIPLES OF CORPORATE GOVERNANCE § 3.02(b)(6). The Principles do not analyze what it means to manage a corporation.

the right steps to take, competitors can simply do the same thing. Of course, when they enter the business thought to be profitable they will drive down its profitability.

The harm to the issuer of disclosure is compounded by the fact that the implementation of significant changes in a business takes time, sometimes lots of time. It can take half a decade or more to complete the downsizing of one business while expanding another, or to design, engineer, produce and market a new product. The longer the lead time, the easier it is for competitors to catch up once the strategy is disclosed.

The ability of competitors to use information is, of course, not quite that simple. Even if managements can obtain information about the strategy of their competitors, they must still decide which competitor they should follow. The answer is to follow the competitor that has the right strategy. But how does one know which competitor has the right strategy without knowing what the right strategy is, in which case there is no need to follow? The answer, of course, is to copy the management best at picking the correct strategy.

Although it is impossible to observe the internal decisionmaking and implementation procedures of managements, an analogy helps explain the argument. Think of a business management as a portfolio manager. The business's portfolio consists of its present activities. Management's problem is to manage the portfolio. This requires it to identify those activities from which it should withdraw (sell the stock) and those activities in which it should invest (buy the stock). To enhance the value of the portfolio, management needs to make the decisions which, ex post, maximize the value of the portfolio.

Since much of the activity of managing portfolios is observable and the results are unblinkingly numeric, there is an empirical literature on that activity. Pursuing that analogy, we know that the managers of portfolios are likely, on average, to obtain results equal to those of the market as a whole.<sup>238</sup> But we also know that some managements will obtain a string of

---

<sup>238</sup> RICHARD A. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 53-63 (2d ed. 1983). The classic study was Michael C. Jensen, *The Performance of Mutual Funds in the Period 1945-1964*, 23 J. FIN. 389 (1968), which found that mutual funds had an average return of 0.1 percent a year less than a comparable index fund.

above-average results. When they do, others begin to copy their moves and the moves become less profitable. Thus in the activity of managing portfolios we observe that managers with a reputation for success will seek confidentiality. To escape the disclosure requirements of the Investment Company Act they organize an offshore fund,<sup>239</sup> or they take control of insurance companies whose portfolios are reported on a delayed and fragmented basis.<sup>240</sup> Even if there is no reason to predict that a manager successful in beating the averages in one year can do it the next, it is clear that a manager who is believed to be successful will lower his chances of success if his competitors mimic his decisions.

Corporate managements face the same problem. Take the simple problem of reporting how much money the business has made. When a successful manager reports that his single-product business is very profitable, other firms will target the business for entry when they see just how profitable the business is. If they do, the profitability of the business will decline. We do not, of course, think of information about the profitability of a business as a trade secret. That is because businesses know how to report their profits in ways which comport with the

---

<sup>239</sup> "Hedge" funds are either organized with fewer than 100 investors (so as to be exempt from the reporting requirements of the Investment Company Act of 1940 § 3(c)(1), 15 U.S.C. § 80a-3(c)(1) (1995), or are organized as off-shore investment funds that are not open to American investors directly. The large hedge funds managed by people such as George Soros, Michael Steinhardt and Bruce Kovner are off-shore. There is a dealer market in London, see Leslie Eaton, *Trouble for Soros-Reichmann Team*, N.Y. TIMES, Sept. 25 1994, at F11, although they are off-shore the U.K. as well. Guernsey, the Isle of Man, Bermuda, Luxembourg and the Republic of Ireland are favored jurisdictions. See Tracy Corrigan, *Not a Basket for all of Your Eggs—Hedge Funds/a Look at the Place of an Instrument That Has Disturbed World Markets*, FT Guide for the Serious Investor, FIN. TIMES, Sept. 17/Sept. 18, 1994, at 12; E. Lee Hennessee, *Flowering Hedges: The Funds Have Had a Very Good Year*, BARRON'S, Dec. 13, 1993, at 16, 1993. No potential investor should make the mistake of assuming that because an investment manager is not subject to public reporting requirements that the manager is successful.

<sup>240</sup> Warren Buffett has gone even farther by increasingly investing through unique, individually negotiated transactions that are not available on the public market. None of these strategies avoid the requirement of § 13(d)(1) of the Exchange Act, 15 U.S.C. § 78m(d)(1)(1994), that any person acquiring more than 5 percent of any securities registered under section 12 of the Exchange Act, 15 U.S.C. § 78l (1994), report the position to the issuer, to each exchange where the securities is traded, and to the Commission. Many of the hedge funds (but not Buffett) appear to be active in markets for products such as currencies and over-the-counter derivatives where there are no position reporting requirements.

securities laws but conceal which of their activities are really profitable. For a single-activity business, however, publicly reporting high profits can be devastating.

These arguments do not support the position that any regulation which reduces the amount of information which firms can protect with secrecy would reduce social welfare. Economic theory, for instance, does not suggest what amount of competitive lead time derived from secrecy is the "right" amount.<sup>241</sup> One can imagine an economy in which the thoughts and plans of all managements would be transparent to the managements of every other firm. Such an economy would still be competitive.<sup>242</sup> It would also be an economy in which innovation and risk-taking would occur less frequently than they do in an economy with greater inherent first-mover advantage.<sup>243</sup> But any system of required transparency between firms cannot be implemented simply by imposing the requirement only on firms subject to the U.S. securities laws. Those firms face competition from firms not subject to the U.S. securities laws—most notably the non-U.S. multinationals.

---

<sup>241</sup> The optimal lead time issue is important in the literature on patents, where economists display a tendency to prefer the natural amount of lead time, whatever it happens to be, and although it differs from industry to industry and activity to activity. Patents are a property right, one of whose effects is to increase the amount of lead time over the amount that would otherwise be available. The literature, on the whole, is uncomfortable with patents. The classic judgment is that of Fritz Machlup: "If we did not have a patent system, it would be irresponsible, on the basis of our present knowledge of its economic consequences to recommend instituting one. But since we have had a patent system for a long time, it would be irresponsible, on the basis of our present knowledge, to recommend abolishing it." FRITZ MACHLUP, AN ECONOMIC REVIEW OF THE PATENT SYSTEM 80, STUDY NO. 15 of SUBCOMM. ON PATENTS TRADEMARK AND COPYRIGHT OF THE SENATE COMM. ON THE JUDICIARY, 85th Cong. 2d Sess., 1958). More recent literature is discussed and cited in Robert Merges & Richard Nelson, *On the Complex Economics of Patent Scope*, 90 COLUM. L. REV. 839 (1990). For a similarly ambivalent reaction to copyrights (which also increase lead time) by a lawyer (and now Supreme Court Justice) influenced by the economics literature see Stephen Breyer, *The Uneasy Case of Copyright: A Study of Copyright in Books, Photocopies and Computer Programs*, 84 HARV. L. REV. 281 (1970).

<sup>242</sup> Although the efforts of firms to facilitate inter-firm communication through trade associations or other devices have been attacked under the antitrust laws. *United States v. Container Corp. of America*, 393 U.S. 333 (1969); *Maple Flooring Mfrs. Ass'n v. United States*, 268 U.S. 563 (1925); *American Column & Lumber Co. v. United States*, 257 U.S. 377 (1921).

<sup>243</sup> This is the point of the FASB CONCEPTS 2, *supra* note 230, ¶ 139, quoted in note 231.

Surely the United States should not require firms subject to U.S. securities laws to share useful commercial information with all of their competitors when many of their competitors are not subject to the same requirement.

## 2. Case Studies of the Implementation of Accuracy Enhancement as Examples of the Problem

The case studies expounded in the first part of this Article can be used to illustrate the types of problems that cause issuers to resist implementation of accuracy enhancement. Why haven't the SEC's efforts to implement the accuracy-enhancement ideal gone smoothly? Of course, there are technical problems, but why haven't the issuers, accountants, securities lawyers and regulators formed one effective team whose shared objective is to iron out the difficulties and move ahead? The short answer is that the issuers have not been willing to help. Why?

### a. *Projections*

At first blush it might seem that projections could have no competitive importance. After all, a projection is nothing but a prediction about what *might* happen. There is a market in the world for predictions, but it is a limited one. The problem with a system for the disclosure of projections is that embedded within projections may be information about how a firm expects to react to the conditions which it anticipates, and this is more likely to be true the more rigorous the projection. Suppose one firm expects sales of its principal product (say insulation) to decline because of a projected decline in housing starts caused by a rise in interest rates. Suppose the firm notices that its principal competitor does not project a decline? Why? A new marketing strategy? A new product? What supports the projection? If the projection is rigorous and informative, it will explain why the fall in housing starts will not have the otherwise expected impact on sales. If the reason is a change in the firm's business strategies, perhaps the competitor should mimic them. Note how the logic of the SEC's proposal for projections led toward the production of more and more information—disclose not only your projections, but the logic behind



your projections, and once you disclose projections, disclose any change in projections, and so on. It is easy to see that once the SEC was committed to a system of projections it would lead to pressures for a better system of projections, which would lead to requirements for the production of more information, and so on.

### b. *Segmentation*

The SEC does require some segmentation, but so many of the rules for the implementation of the segmentation requirement are left to the discretion of the individual issuer that it is unlikely that they lead to the disclosure of much information of competitive or investment value. Activities can be grouped and costs allocated in so many different ways that it would be difficult, if not foolhardy, for a competitor to use segmented FASB data as a blueprint for one's own competitive strategy. The problem of competitive harm is particularly unimportant for relatively large, multiproduct firms.

The defects in the present segmentation requirements lead to demands for better segmentation. For instance, more than ten significant changes in required segmenting procedures suggested by the Association for Investment Management and Research (which represents 23,000 professional financial analysts worldwide) were prominently reported in a recent FASB research report, *Reporting Disaggregated Information*.<sup>244</sup>

Additional precision and detail in the segmentation requirements would provide additional relevant data for financial analysts to understand and use to make predictions about issuers. But it would also increase the ability of competitors and others to understand issuers' areas of vulnerability and strengths and weaknesses, and thereby be better able to develop successful competitive strategies. *Reporting Disaggregated Information* contains a chapter summarizing views of financial analysts, lending and credit officers, financial information publishers and other users of financial reports.<sup>245</sup> It contains no material on the views of the producers of financial reports.

In a concluding chapter, *Reporting Disaggregated Informa-*

---

<sup>244</sup> PACTER, *supra* note 79, at vi-vi.

<sup>245</sup> PACTER, *supra* note 79, at iii, 59-116.

tion identifies twenty-seven issues requiring twenty-three pages to describe what the FASB should consider in connection with a reevaluation of the segmentation requirements. Only one issue deals with the issue of possible harm to the entity subject to the standards. It is:

ISSUE 21: Can *specific* examples be found of how Statement 14 disclosures have been harmful to competition, and what changes should be made to the Statement to ameliorate the harm in the future? For example, should companies be allowed to omit disclosures that management deems competitively harmful, with disclosure of the omission?<sup>246</sup>

What, the reader wonders, is a sufficiently specific example to be relevant? And why are examples of harm under the existing requirements the only issue. What about harm under any of the proposed changes?

### c. MD&A and the Caterpillar Case

It is impossible for a management to prepare a "good" MD&A disclosure—that is, a disclosure that truly achieves the objectives of the required disclosure—without revealing a good deal about what it thinks about its businesses, the markets in which its businesses operate, and how those markets will evolve. That is inherent in the very analytic process which the disclosure solicits. But there is the further problem that the disclosure may aggravate the very problem that management is attempting to address. Take the example of Caterpillar's business in Brazil. Caterpillar was, presumably, quite worried about what to do about its business in Brazil. Would it have helped if Caterpillar had disclosed, in the midst of the political transition going on in Brazil, that nearly one-quarter of its worldwide profits came from its Brazilian subsidiary? Aside from the fact that such a disclosure might have been misleading because the results reflected accounting conventions and not economic reality,<sup>247</sup> could not such a disclosure have led to attacks from politicians in Brazil that Caterpillar was "prof-

---

<sup>246</sup> PACTER, *supra* note 79, at 225 (emphasis added). A number of foreign accounting systems permit managements to omit segment information if they determine that such information would be competitively harmful, with disclosure of the omission. PACTER, *supra* note 79, at 52.

<sup>247</sup> See the discussion *supra* note 144.

it gouging" the Brazilian people? Brazilian officials certainly would have said: "Can you believe it? Caterpillar operates all over the world, in the United States, in Japan, in Europe, and yet last year they made almost a quarter of their enormous profits off the backs of the Brazilian people. Something must be done." That something might not have been very good for Caterpillar.

#### d. *Merger Negotiations: Basic*

Why didn't the *Basic* management simply disclose the merger negotiations? Why do managements now say "no comment," rather than disclose the truth? One explanation that has been offered is that suitors in a merger situation want secrecy in order to avoid competing bids. That is, prospective suitors will be reluctant to make a serious offer if they predict that their offer will simply be used to interest another suitor.<sup>248</sup> Another explanation is that anything that increases the

---

<sup>248</sup> "One specter facing any potential buyer is the winner's curse—the prospect that the high bidder wins the auction only because he alone has placed an unrealistically high value on the assets." *Flamm v. Eberstadt*, 814 F.2d 1169, 1176 (7th Cir. 1987) (Easterbrook, J.).

News that merger negotiations were in progress would signal to other investors that *Basic* was an attractive merger prospect, allowing them to "free ride" on Combustion's investment in information about *Basic*. The simple identity of valuable takeover targets is information that lends itself to free riding. This is because the identification of a firm such as *Basic* as a likely takeover target "signals to other investors that undervalued assets have been located. Because the subsequent bidders have incurred no costs to acquire information, they can offer more to target-firm shareholders, forcing the initial bidder to increase her offer or lose the opportunity to acquire the target firm." The free-rider problem adversely affects investor wealth maximization to the extent it discourages acquirors who would otherwise pay shareholders a takeover premium for the shares they own. After all, "no firm wants to be the first bidder unless it has some advantage, such as speed, over subsequent bidders to compensate for the fact that only it had to incur monitoring costs. And, of course, if there is no first bidder there will be no later bidders and no tender premium." For this reason, among others, it is well settled that premature disclosure of merger discussions may thwart the merger, thereby "destroying the source of the value sought to be disclosed."

Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1069-70 (1990). Macey and Miller would permit management to issue false statements to further this interest. *Id.* at 1071. In fact, *Basic* may not have been a good example of this point, since there were unique advantages to a merger between the particular

verifiable certainty that a merger will occur is likely to increase the percentage of stock held by arbitrageurs, who will put increasing pressure on management to strike a deal, even if they must accept terms somewhat less attractive than those that could be obtained from harder bargaining.

e. *Market-Value Accounting*

Market-value accounting presents a number of different problems for issuers. First of all, issues of valuation present uncertainties which can become matters for litigation. Under a cost-based system, the issuer can always defend on the grounds that the balance sheet disclosed the cost. In a market-value system, on the other hand, the plaintiffs can always argue that a valuation was wrong. If the values have fallen or risen sharply from the amounts used on the balance sheet, they may seem, with the benefit of hindsight, to have been prepared with the required scienter.

Second, a market-value system requires the collection of information that the issuer would not have to collect on a regular operating basis. Although managements need to have some idea of what their assets are worth in order to properly determine whether they should be sold, precise value information is not something they will prepare annually with sufficient care to withstand possible Rule 10b-5 liability. The ease of valuing particular assets turns on whether they are regularly traded in markets with public price reporting, even though those publicly reported prices are nothing more than a consensus of individual estimates, none verifiable. The securities whose valuation is required by FASB 115 can be valued easily, perhaps even automatically valued by a computer programmed to download market prices. Real estate can be valued based on information provided by actual transactions whose prices are in the public record, applying appropriate adjustments to reflect the lack of perfect comparability. But as the asset becomes more specialized to the business—custom-designed machinery, trademarks, intangible assets—the problem of deter-

---

parties, to judge by the fact that Combustion Engineering (the acquiror) pursued Basic consistently for thirteen years. See the chronology in *Levinson v. Basic*, 786 F.2d 741, 743-45 (6th Cir. 1986).

mining a value for the asset comes closer and closer to the problem of making forecasts about the business in which the firm competes, for the value of these specialized assets is nothing more than the present value of the cash flows they will generate when used in business.<sup>249</sup>

The financial institutions most directly affected by FASB 115 (because of the high proportion of qualifying securities on the asset side of their balance sheets) objected vehemently to FASB 115.<sup>250</sup> They objected to the fact that it required market valuation of a portion of the asset side of the balance sheet, but of no portion of the liability side, with the result that FASB 115 would cause economically meaningless changes in net worth.<sup>251</sup> They argued that to avoid this effect bankers

---

<sup>249</sup> Tom Lee, *Mark to Market: The U.K. Experience*, J. OF ACCT., Sept. 1994, at 84, reports on a trial run in the U.K. with mark to market accounting, which, among other things, obtained reactions from issuer management:

Preparing the company's market-value based accounting statements proved to be relatively easy. However, the statement preparation was influenced by senior management's longtime use of historical costs and its doubts about the relevance of market values and was constrained by the difficulty of obtaining market value data for special or unmarketable assets.

*Id.* at 86. After the trial run, a group of accountants recommended using "a mix of current value methods appropriate to the assets being reported" rather than only net realizable current value. *Id.* at 88.

<sup>250</sup> The controversy is reviewed as of 1991 in Donald J. Kirk, *Commentary: Competitive Disadvantage and Mark-To-Market Accounting*, 5 ACCT. HORIZONS, June 1991, at 98. U.S. banks were required to use market-value accounting prior to 1938. In that year the U.S. Treasury and the bank regulators changed their position, and required cost-of-acquisition accounting. *See id.* at 102-03. The background of the 1938 accord is reviewed in Donald G. Simonson & George H. Hempel, *Banking Lessons from the Past: The 1938 Regulatory Agreement Interpreted*, 7 J. FIN. SERVS. RES. 249 (1993). The authors conclude that the 1938 accord was based not on normative accounting principles but on a desire to ease bank credit.

<sup>251</sup> To take a simple example, assume a bank owns \$1,000,000 of 5-year U.S. government notes paying six percent. It also has \$1,000,000 in deposit liabilities on five year certificates of deposit paying four percent. Interest rates rise. The value of the government notes fall, but so does the present value of the liability claim. If these offset, there is no impact on net worth. Under FASB 115, net worth is reduced. The structure of the arguments for and against the market valuation approach is the same. That is, both sides argue that the proposal they oppose would lead to "unreal" results. The advocates of market value accounting argued that cost accounting was "once upon a time" accounting that would lead to artificial behavior, such as the sale of appreciated portfolio securities in order to affect reported net income. *See* testimony of SEC Chairman Richard Breeden, *supra* note 186 and accompanying text.

would change their investment strategies, particularly by reducing investments in long-term instruments, whose values are more strongly affected by changes in interest rates. Moreover, the critics implied that FASB 115 would even create problems in the government bond market.

It is difficult to determine from the banker's complaints why a change in the volatility of their reported net worth would change their behavior.<sup>252</sup> One explanation would be that the change in the accounting procedure would affect banking regulation. The mark-to-market valuation procedure would be incorporated into the minimum capital requirements, so that the change in the reported balance-sheet net worth would change the way they would have to respond to the regulation. In turn, they face competition for loans with banks from other jurisdictions who might not be subject to the same rule. If the regulatory consequences of the accounting procedure changed their real costs, they would be disadvantaged in this competition.<sup>253</sup>

---

<sup>252</sup> Within months of the adoption of FASB 115 the American Bankers Association and the Independent Bankers Association of America were claiming that FASB 115 had already affected bank behavior, most notably causing banks to shorten the maturities of their asset portfolio. *Bankers' Dire Predictions on FASB 115's Bad Effects Are Coming True, Groups Warn*, 62 BANKING REP. (BNA) No.62, at 698 (April 18, 1994). On February 14, 1995, Federal Reserve Governor John LaWare said in a speech to the Independent Bankers Association of America that "Financial Accounting Standards Board Standard 115 has weakened investment portfolio positions and will continue to add volatility to bank balance sheets." *Regulatory Relief, Expanded Powers on Horizon for Banks, Laware Tells IBAA*, 64 BANKING REP. (BNA) No. 64, at 361 (Feb. 20, 1995).

<sup>253</sup> I have not found a place where this is argued explicitly. See Walter Wriston, *'Mark to Market': Wild Accountants' Crazy Idea*, WALL ST. J., June 11, 1992, at A14. Although a passionate and quite eloquent tirade against FASB 115 by an elder statesman of the banking industry, (former CEO of Citibank), it does not make this point. Wriston's basic argument is that balance sheets already reflect numerous "artificial" conventions (such as the failure to value numerous intangibles as an asset) so that a reform designed to eliminate one such convention out of many on the ground that it is "artificial" makes little sense. *Id.* Donald G. Simonson, *Marking-To-Market: Is It Any Way to Run a Bank?*, U.S. BANKER, Nov. 1992, at 64, dismisses the bankers opposition on the ground that "The essence of such criticisms is that better information is economically dangerous. Most economists argue that, on the contrary, fuller information is important to insure that markets operate efficiently." See also Donald G. Simonson, *Securities Accounting: Half a Loaf*, U.S. BANKER, Jan. 1993, at 49. In spite of the title, Kirk, *supra* note 250, only refers to and criticizes a speech by SEC Commissioner Philip R. Lochner arguing that FASB fails to take the impact of its standards on international competition into account. Why was the argument from regulatory requirements not made? One possible explanation is that the bankers wanted to reserve the option

Ironically (because the move towards market-value balance sheets has been justified by the example), a market-value balance sheet does not reveal the basic problem that got the savings and loans into difficulty in the first place; that was a failure of the maturities of their assets and liabilities to match. Thus before the rise in interest rates that led to their insolvency, their market-value balance sheets would have shown that they were solvent, but would not have revealed the maturity mismatch that made their solvency so fragile.

#### *f. Portfolio Managers*

Finally, why haven't investment companies been eager to disclose the identity of portfolio managers? If the disclosure documents identify the portfolio manager, it would be possible for third parties to compile performance records for particular portfolio managers. Those who compiled a good record would acquire a valuable reputation in the market. The portfolio manager can then bargain for higher compensation by threatening to take his or her reputation and go elsewhere. The investment companies want the public to be loyal to the company, not to the individual portfolio manager. Many investment companies have avoided the impact of the new disclosure

---

that if FASB 115 was adopted (as seemed very likely once Richard Breeden had been so emphatic, *supra* note 186 and accompanying text) they could then argue to the regulators that the regulators should not change their rules to reflect the changes of FASB 115. This is in fact what happened. The Federal Reserve, for instance, first proposed, 56 Fed. Reg. 68563, Dec. 28, 1993, but then did not adopt FASB 115 for purposes of computing regulatory capital. 59 Fed. Reg. 63241 (1994). So did the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation. See *OTS Reverses FASB 115 Compliance Policy, Ending Requirement for Thrifts*, BANKING REP. (BNA) No. 64, at 833 (Dec. 5, 1994); *FDIC Approves Several Final Rules, 1995 Budget, and Technical Amendments*, BANKING REP. (BNA) No. 64, at 9 (Jan. 2, 1995). Only the credit-union regulator did so, to the dismay of the credit unions. See *CUNA [The Credit Union Association] Suggests NCUA [The National Credit Union Administration] Delay Effective Date Requiring Credit Unions to Adopt FASB 115*, BANKING REP. (BNA) No. 64, at 36 (Jan. 2, 1995). The leading opponents of using FASB 115 in the computation of bank capital were the smaller banks, and their arguments were the same that had been made against FASB 115 itself. The Shadow Financial Regulatory Committee criticized the banking regulators for their failure to incorporate FASB 115 into their minimum capital standards. *Group Wants Ban on Charter Flips Lifted, Criticizes Regulators for Snubbing FASB*, BANKING REPORT (BNA) No. 63 at 920 (Dec. 19, 1994).

requirements by placing responsibility for investment decisions on a group, rather than an individual.<sup>254</sup>

### 3. The History

Why, if the need for secrecy is an important problem under the securities laws, hasn't the point been made frequently and vehemently by issuers? The answer is that the securities laws have not required the disclosure of sensitive information. The accuracy enhancement goal, however, requires that they do, and if implemented, would make the problem a serious one.

The need for confidentiality was, in fact, a credible argument in the formative years of the securities laws. Arguments

---

254

When the SEC does try to improve disclosure, funds often race to find the nearest loophole. After the agency began requiring greater disclosure about fund managers, many funds, including a number from Invesco, changed from divulging the names of lead managers to claiming the funds were under the direction of co-managers or teams, which allows them to skirt the new rules. (Invesco claims its funds have always been team-managed.) About a third of the funds surveyed by Morningstar now say they have a team of two or more managers, more than twice the number just five years ago. In its fund prospectus, T. Rowe Price tells prospective shareholders only how long a fund manager has worked for the Baltimore company and the length of time he or she has been investing. No further information about his professional background is given. Argues Jane White, director of shareholder communications: "Whether he went to Harvard or keeps bees or managed taxable bonds and is now managing municipal bonds doesn't add that much."

Stewart & Cramer, *supra* note 214, at 98, 100. See also, Don Phillips (publisher of Morningstar Mutual Funds), *What Mutual Funds Don't Tell You, Important Information that Could be Dangerous to Your Wealth*, BOTTOM LINE, July 15, 1994 at 1 ("So why do funds prefer to say that they are run by committee? Because when the key manager leaves the fund, investors may leave with him/her.").



based on an issuer need for secrecy were only briefly voiced<sup>255</sup> in the hearings on the Exchange Act. A section was added to the Exchange Act specifically addressing trade secrets. As enacted, section 24(a) provided, "Nothing in this title shall be construed to require, or to authorize the Commission to require, the revealing of trade secrets or processes in any application, report, or document filed with the Commission under this title."<sup>256</sup> Section 24(b), in turn, provided a procedure for persons filing a document to object to its public disclosure, and that "The Commission may, in such cases, make available to the public the information contained in any such . . . document *only* when its judgment a disclosure of such information is in

---

<sup>255</sup> I have located only two places where this argument against disclosure is made in the hearings on the Exchange Act. First:

Sections [22] and [24] of the bill provide that all hearings before the Commission shall be public and that all information received by it shall be public records. The latter provision, which would seem to require that all information which the Federal Trade Commission may receive from corporations must be made available to any person who wishes to examine it, may result in putting American business at a distinct disadvantage in competing with foreign enterprises. We all know that every important business has trade secrets and processes and formulas which have value chiefly because they are not available to competitors. In like manner, many of the statistics in regard to the operations of companies are of little value to stockholders and investors, but of inestimable worth to competitors. These provisions requiring publicity may, therefore, have very serious consequences.

*A Resolution to Investigate Practices of Stock Exchanges with Respect to the Buying and Selling and the Borrowing and Lending of Listed Securities: Hearings on S. Res. 84 before the Senate Comm. on Banking Currency, 73rd Cong. 1st Sess., reprinted in 6 LEGISLATIVE HISTORY OF THE SECURITIES EXCHANGE ACT OF 1934, 6640 (1973) (J.S. Ellenberger et al., eds. 1973) (Statement of Richard Whitney, President of the New York Stock Exchange in Regard to H.R. 7852). Second:*

Sections [22] and [24], relating to publicity of all hearings, records, reports, and documents will be welcomed by thousands of competitors of those whose success has depended upon legitimate business secrets, such as secret processes, ideas, etc. This may well destroy the property right of every corporation in its good will, its method of doing business, the development of ideas for its benefit, and similar intangible property. It will also be welcomed by all who engage in the bringing of strike suits against corporations.

*Id.* at 7020 (Letter from the New York Airbrake Co., Feb. 27, 1934). Thomas Corcoran's answer to these arguments is quoted in the text, *supra* note 228 and accompanying text.

<sup>256</sup> Securities and Exchange Act of 1934, 48 Stat. 901 (June 6, 1934) (codified as amended at Title I § 24, ch. 404, 15 U.S.C. § 78 (1994)). The Securities Act of 1933 contained no comparable provision, probably because its provisions could be avoided completely simply by not making a public offering.

the public interest.<sup>257</sup>

In the floor debates, an argument based on issuer need for secrecy was one of the points made by the opponents of the Exchange Act in spite of Section 24. For example, one Senator argued that:

The objection was raised before the committee that the commission could require the divulging of trade secrets. The committee provided against that by appropriate language. But there is still in this section [12, requiring registration] an absolutely unrestrained power in the commission to require of corporations information which, al-

---

<sup>257</sup> *Id.* § 24(b) (emphasis added). Section 24 was amended by the Securities Act Amendments of 1975, Pub. L. No. 94-29 § 19, 89 Stat. 158 (codified as amended at 15 U.S.C. § 78x (1994)). The purpose of the amendment was to conform the statute to the provisions of the Freedom of Information Act. Subsection (b) of the amended section prohibits disclosure of any records "(1) in contravention of the rules and regulations of the Commission under section 552 of Title 5, United States Code [the Freedom of Information Act] or (2) in circumstances where the Commission has determined pursuant to such rules to accord confidential treatment to such information." 15 U.S.C. § 78x(b) (1994). The right to seek confidential treatment from the Commission continues under the Securities Act, Rule 406, 17 C.F.R. § 230.406 (1995), and under the Exchange Act, Rule 24b-2, 17 C.F.R. § 240.24b-2 (1995). Rule 406 does not set out the ground on which the Commission might grant confidential treatment, but does require the applicant for confidential treatment to provide "a detailed explanation of why, based on the facts and circumstances of the particular case, disclosure of the information is unnecessary for the protection of investors." 17 C.F.R. § 230.406(b)(2)(iii) (1995). One situation where requests for confidential treatment apparently are made with some success is where a material contract required to be filed with the Commission under Item 601(a)(10) of Regulation 17, 29 C.F.R. § 229.601(b)(10) (1995), which contains nonmaterial information whose disclosure would have competitive implications for the issuer. See Comizio, *supra* note 213, at 789-90. An example might be a pricing formula contained in an important supply contract. Rule 24-b provides that the grounds for confidential treatment are those items exempt from disclosure under its Freedom of Information Act regulations, 17 C.F.R. § 200.80 (1995). The most likely exemption is exemption 4: "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 17 C.F.R. § 200.80(b)(4) (1995). Of course, the reference is circular, since if the Commission denies confidential treatment, the information no longer qualifies. The Freedom of Information Act regulation, 17 C.F.R. § 200.80 (1995), describes numerous documents that may qualify, but does not mention documents required to be filed. Comizio cautiously concludes: "arguments under exemption 4 for nondisclosure of commercial and financial information may be of limited utility due to the circumstances under which such information is required to be disclosed pursuant to the public disclosure goals of the securities laws." Comizio, *supra* note 213, at 806. Carl W. Schneider et al., *Going Public: Practice, Procedure and Consequences*, in SECURITIES REGULATION 164, 171 (Richard W. Jennings, ed., 7th ed. 1992), excerpted from a 1988 version of Schneider, *supra* note 214, offers an understated conclusion worthy of securities lawyers, which, of course, they are: "[I]t is difficult to obtain confidential treatment as a practical matter."

though not falling within the definition of trade secrets, is nevertheless very confidential in its character. There is still in this section the complete and full possibility that the commission may at any time require of any corporation disclosure of facts which will be very beneficial to the competitor of that corporation.<sup>258</sup>

The concerns about secrecy in the debates and during the earlier years of the act can be better understood in the context of the coverage of the Securities Acts as first passed. The Securities Act could be avoided by not engaging in a public offering. The disclosure requirements of the Exchange Act were little different from those already imposed by the New York Stock Exchange.<sup>259</sup> The original Exchange Act, however, was not limited to companies listed on exchanges. It also extended disclosure requirements to unlisted issuers traded on exchanges, and gave the Commission power to require registration of any company whose securities were traded in the over-the-counter market. Commission power to require disclosure from issuers whose securities were traded in the over-the-counter market was included out of a fear that issuers might flee the exchanges for the over-the-counter market.<sup>260</sup> The original

---

<sup>258</sup> 78 Cong. Rec. 8274 (1934) (statement of Sen. Steiwer). He returns to this argument at 78 Cong. Rec. 8277 (1934). See also 78 Cong. Rec. 8284 (1934) (statement of Sen. Walcott) and 78 Cong. Rec. 8497 (1934) (Statement of the National Automobile Chamber of Commerce submitted by Sen. Hastings).

<sup>259</sup> "In order for a corporation to list its securities on the New York Stock Exchange the rules of the exchange require it to furnish all the information provided for in this bill except that concerning salaries and bonuses." 78 Cong. Rec. 1934-35 (May 2, 1934) (statement of Rep. Chapman).

Now, I want to say that before a man can list his stock on the New York Stock Exchange, he may be required to file that much or more [as the disclosures required by the act] (apart from the disclosure of bonuses, which certainly the investing public has a right to know), but there seems to be a fear running around that the Government is going to regiment business.

78 Cong. Rec. 7697 (April 30, 1934) (statement of Rep. Rayburn). "They [provisions for decent and frequent corporate reports] simply standardize requirements which the stock exchanges are already making at a standard which offers at least a beginning of protection against the concealment of management interests of investors who have hitherto bought into listed securities almost entirely blindly." 78 Cong. Rec. 7699 (April 30, 1934) (statement of Rep. Rayburn).

<sup>260</sup> "Frankly, this section of the bill protects the legitimate exchange from the over-the-counter fellows in having them run from the exchange to the unregulated market." 78 Cong. Rec. 8036 (May 3, 1934) (statement of Rep. Rayburn).

The language of section 15 is calculated to cause those corporations to remain upon the exchange because it will let them know that they will be subject to regulation, either on the exchange, or if they try to avoid

## Section 15 provided:

It shall be unlawful, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest and to insure to investors protection comparable to that provided by and under authority of this title in the case of national securities exchanges, (1) for any broker . . . to make use of the mails or any means or instrumentality of interstate commerce for the purpose of making . . . a market . . . for both the purchase and sale of any security. . . . Such rules and regulation may provide . . . for the registration of the securities for which they make or create a market.<sup>281</sup>

Because of Section 15, a theme of opponents of the Exchange Act was that it was not simply a statute about the exchanges and securities brokers, but that it was a regulatory regime that could potentially reach almost every issuer of non-exempt securities in the United States.<sup>282</sup> This meant that the information disclosure requirements could reach most businesses of any size, including those far too small to be listed on

---

the regulatory powers provided for in the bill and endeavor to have their securities traded in over the counter, they will meet the same regulation.

78 Cong. Rec. 8186 (May 7, 1934) (statement of Sen. Byrnes).

<sup>281</sup> 48 Stat. 901 (June 6, 1934) (codified as amended at Title I § 15, 15 U.S.C. §78k-1(c) (1994)).

<sup>282</sup> "So that the Commission could indirectly, under the bill, control every industry in the United States if it wanted to." 78 Cong. Rec. 7710 (April 30, 1934) (statement of Rep. Britten).

What justification, I ask, is there for the enactment of legislation which places the business of the United States in a strait-jacket of this kind? . . . We are dealing with honest enterprise; we are dealing with legitimate investment; and the good with the bad are going to be brought within the strictest requirements of this measure, held down by sections 12, 13 and 19, if they attempt to operate upon the stock exchanges, and then driven back to the stock exchanges by section 15 if they attempt to sell their securities in the market over the counter.

78 Cong. Rec. 8279 (May 8, 1934) (statement of Sen. Steiwer). This reading of § 15 was contested by supporters of the bill:

But those who tell you that the over-the-counter provisions of the bill will interfere directly or indirectly with the small industrial concern are either willfully misleading you or are ignorant of what the bill really does. The control of the Commission with respect to the over-the-counter markets may be exercised only over dealers or brokers who maintain a public market.

78 Cong. Rec. 7868 (May 1, 1934) (statement of Rep. Maloney). In a long colloquy in the Senate between Senators Dill, Barkley, Black and Byrnes, 78 Cong. Rec. 8190-8191 (May 7, 1934), the argument was made that the Commission would not exercise its power in full.

an exchange. This potential reach of the statute added cogency to the concerns about confidentiality.

In any event, the original reach of the original section 15 was never implemented. In 1936 the SEC recommended, and Congress passed, amendments which removed this jurisdiction from the SEC.<sup>263</sup> Joel Seligman attributes the Commission's position to concerns about the reach of the interstate commerce power.<sup>264</sup> Another possible reason is that the Commission found its administrative and political agendas full enough without having to deal, as well, with the imposition of disclosure practices on over-the-counter issuers who had never been subject, and never expected (prior to 1934) to be subject to disclosure requirements. And by 1936 it must have been clear that the Exchange Act was not going to cause wholesale flight from the exchanges by issuers.

In the early period after passage of the Exchange Act, many companies sought trade-secrecy protection for information relating to their profitability.<sup>265</sup> At first the Commission granted many of these requests,<sup>266</sup> but then turned to a policy of denying them routinely, without a hearing.<sup>267</sup> The companies sought review in the District of Columbia Court of Appeals (the predecessor to the United States Court of Appeals for the District of Columbia). At the end of 1937, fifteen cases were pending.<sup>268</sup> The Commission argued that its orders de-

---

<sup>263</sup> Pub. Law 74-462 § 3, amending Securities and Exchange Act of 1934 § 15, 49 Stat. 1377 (May 27, 1936) (codified at 15 U.S.C. §78l-i (1995)). The same act also extended exchange trading privileges for grandfathered unlisted securities indefinitely. Pub. Law 74-462 § 1, amending Securities and Exchange Act of 1934 § 12(f), 49 Stat. 1375 (May 27, 1936) (codified at 15 U.S.C. §78o-1 (1995)).

<sup>264</sup> SELIGMAN, *supra* note 4, at 142.

<sup>265</sup> In the year ended June 30, 1936, 631 registrants objected to publication of 966 items of information, and 218 companies objected to disclosure of matter in annual reports. SECURITIES EXCHANGE COMMISSION SECOND ANNUAL REPORT 25 (1936), as summarized in Comment, *Confidential Treatment of Information Required by the Securities Exchange Act*, 47 YALE L.J. 790, 792 n. 17 (1938) [hereinafter "YALE Comment"].

<sup>266</sup> "For some time, however, the Commission granted confidential treatment rather freely in these type situations." YALE Comment, *supra* note 265, at 795.

<sup>267</sup> "[W]hen investigations revealed that in many cases competitors or customers already had obtained the disputed information either through underhand activities or from other public records, and that the figures had little effect upon buying policies, the number of exemptions decreased." YALE Comment, *supra* note 265, at 795.

<sup>268</sup> As of June 30, 1937, 31 petitions for review had been filed, but 16 were

nying confidential treatment were nonappealable. The Court rejected the Commission's arguments in an opinion which stressed the importance which Congress had placed on business confidentiality in the statute, and even suggested that were not the interest protected by a hearing and a right of judicial review, the statute would be unconstitutional.<sup>229</sup> Thereafter, the case was returned to the Commission for a hearing. The American Sumatra Tobacco Corporation became the only continuing litigant.<sup>270</sup> The Commission wrote a long fact-specific opinion justifying the denial of confidential treatment on the specific facts, without taking any general position.<sup>271</sup>

A Yale comment, generally supportive of the Commission effort to resist requests for confidentiality, reports two arguments made by issuers seeking confidential treatment in situations where the comment said "confidential treatment may well be in the public interest":

In the first, a relatively small company, most of whose output is sold to one large buyer, will attempt to show that publication of its mar-

---

voluntarily dismissed. SECURITIES EXCHANGE COMMISSION THIRD ANNUAL REPORT 179 (1937), as summarized in YALE Comment, *supra* note 265, at 792 n.18.

<sup>229</sup> American Sumatra Tobacco Corp. v. SEC, 93 F.2d 236 (D.C. Cir. 1937). The decision was forcefully criticized in YALE Comment, *supra* note 265. The comment concluded:

it might be well to create a presumption of public interest in any item required by the Commission's rules to place something akin to the burden of proof upon anyone demanding confidential treatment. The language of the Act may seem to stand in the way. . . . it seems clear that the purpose of the Act is to make publicity the norm and confidential treatment the exception.

YALE Comment, *supra* note 265, at 798.

<sup>270</sup> Why this is so is not clear. Perhaps the issuers seeking confidential treatment selected American Sumatra to carry a test case forward. As early as February, 1936 (the date of the SEC's legislative proposals amending §§ 12(f) and 15) it must have been clear that issuers who were traded in the over-the-counter market and who did not make a public offering would never be subject to disclosure requirements. Another factor probably was that the issuers learned how to comply with the act in ways that would not affect their business. For instance, profitable single-product companies combined with other businesses so the profitable product line could no longer be identified, or they delisted from an exchange. As explained in the text following this note, American Sumatra was in a particularly invulnerable competitive position and thus may have been more willing than others to be the test case.

<sup>271</sup> *In re American Sumatra Tobacco Corporation*, 7 S.E.C. 1033 (1939), Release 34-2628, 1939 WL 1345 (Feb. 1, 1939) [hereinafter "Release 2628"].

gin of profit will give the buyer an additional lever with which to demand lower prices. Second, companies whose competitors need not disclose their margins of profit because they are not listed on any exchange may contend that the latter will acquire various competitive advantages, such as an opportunity to persuade buyers that the registrant's margin of profit, which has become a matter of public record, is excessive.<sup>272</sup>

Neither argument is very persuasive, since buyers should care more about the price they pay than the seller's profit.<sup>273</sup>

From a vantage point more than half a century later, it is striking how seriously the Commission took the arguments. Not only was the opinion in *American Sumatra* lengthy, the Court of Appeals opinion in the *American Sumatra* case tells us that the abstracted administrative record on appeal occupied 703 printed pages. It is also striking how unpersuasive the arguments of *American Sumatra* were. The *American Sumatra Tobacco Corporation* was a single-product company<sup>274</sup> listed on the New York Stock Exchange. Most of its competitors were not publicly held. It grew, harvested, cured and sold cigar-wrapper tobacco. And its accounting statements showed that it made a lot of money, with a high margin between its sales revenue and the cost of goods sold. The company sought confidential treatment of its figures as to sales and cost of goods sold, so that it could begin its profit-and-loss statement with its net profit from goods sold.

The analysis here suggests that *American Sumatra* should have objected to the disclosure of the information on the

---

<sup>272</sup> YALE Comment, *supra* note 265, at 795.

<sup>273</sup> Of course if the buyer has the ability to substitute its own production, or to induce alternative suppliers to enter the market, knowledge of the seller's profits will be very important information, and the threat that the seller will be replaced if the prices are not lowered very real.

<sup>274</sup> Or about as single product as a company is likely to be. *American Sumatra* in fact produced two different grades of cigar-wrapper tobacco, Type 61, grown in the Connecticut Valley of New England, and good for fancy cigars, and type 62, grown in Georgia and Florida, and used for cheap cigars. Release 2628, *supra* note 271, at 4, 9.

It follows also that the contention of the registrant that it produces only one product is without substance. The existence of many different grades selling for widely different prices, together with the fact that the demand of many manufacturers is for specific qualities of grades of Type 61 or Type 62 and not for wrapper in general, demonstrates that the different types and grades are treated in practice as different commodities.

Release 2628, *supra* note 271, at 10.

ground that public disclosure of the fact that growing cigar-wrapper tobacco was a very profitable business would attract new competition, decreasing its profits. The objection seems to have been but weakly made. The opinion of the SEC discloses facts that suggest why American Sumatra could not make such an argument. The wrapper-tobacco industry was subject to control by the Agricultural Adjustment Administration.<sup>275</sup> The marketing agreement in effect for wrapper tobacco prescribed minimum prices and allocated production acreage. There would be no entry in the business, no matter how profitable.<sup>276</sup>

American Sumatra instead made an argument much like that reported in the Yale comment. If American Sumatra's customers knew how much money it was making, it would be forced to lower its prices. The Commission explained the argument:

Since its customers, the cigar manufacturers, are in position to stay out of the market for one or two years [because of their inventory of wrapper tobacco], they would, if they knew the registrant's profit margin, refuse to purchase its tobacco unless it reduced its profits by lowering its prices; . . . [and] since the registrant is the only company engaged exclusively in the business of growing, processing and selling wrapper tobacco which has securities listed on a national securities exchange, disclosure of its sales and cost of sales would be disadvantageous to it from a competitive standpoint.<sup>277</sup>

Much of the SEC opinion declaims on the value of information about profit margins for investors. It is an early and quite eloquent exposition of the accuracy-enhancement goal. The opinion provides:

To particularize, one of the essential purposes of the profit-and-loss statement is to furnish the investor or prospective investor with adequate historical data definitive of past earning power, and of

---

<sup>275</sup> Release No. 2628, *supra* note 271, at 8.

<sup>276</sup> The control program also would have explained the high profit margin of American Sumatra's accounting statement. The base acreage allocations were in fact an asset but would not have had their value reflected either on the balance sheet, nor any proportional depreciation cost reflected in the income statement. American Sumatra might have feared that disclosure that it was making a lot of money because of the government's price control program could have contributed to political pressures to change the program to the detriment of American Sumatra. It did not make this argument.

<sup>277</sup> Release 2628, *supra* note 271, at 4. The Commission did not consider that purchasers might extrapolate from the financial statements of American Sumatra that all growers of wrapper tobacco were likely to have high profit margins.



prime importance in forecasting future earning power. . . . If the factors contributing to the wide profit margin cannot be duplicated, strength may be indicated. To the extent that the contributing factors may not be lasting, weakness may be indicated. So a wide profit margin constitutes a warning signal; the investor must determine to what extent the margin is likely to continue.<sup>278</sup>

The case then returned to what is now the United States Court of Appeals for the District of Columbia Circuit.<sup>279</sup> Again, the court treated the issue as a serious one. According to the court:

[W]e can also say that we have no difficulty in understanding petitioner's reasons for apprehension that the disclosure will be harmful, and if the question were before us as an original proposition, we could easily see our way to sustaining the objections to general publication. . . . In this case the Commission has not justified its position on the ground of a general rule or a general policy. If it had, the case would have been different and would have demanded different treatment.<sup>280</sup>

Based on the Commission's firm-specific findings in the record, the Court of Appeals affirmed.

So ended the challenge to securities disclosure based on the need for secrecy. By then most issuers had learned that the disclosure requirements of the Exchange Act did not affect their business, or if they did, had modified their businesses so disclosure would not be threatening, or had delisted from an exchange, finding immunity from disclosure regulation in the over-the-counter market.

### III. THREE APPLICATIONS: INSIDER TRADING, THE SCOPE OF THE IMPLIED CAUSE OF ACTION AND THE ROLE OF ISSUER WELFARE IN DISCLOSURE AND ACCOUNTING RULES

Mandatory disclosure requirements are not correctly understood as simply a matter of disclosure, more disclosure, and still more disclosure in pursuit of accurate market valuations. Accuracy enhancement is but one of many goals of the disclosure mandated by securities regulation. Other and competing

---

<sup>278</sup> Release 2628 *supra* note 271, at 6. The Commission did not consider that publication of a wide profit margin might contribute to the speed of this decline.

<sup>279</sup> *American Sumatra Tobacco Corp. v. SEC*, 110 F.2d 117 (1940).

<sup>280</sup> *Id.* at 121.

goals include the welfare of the issuer, restraints on fiduciary abuse, control of promotional practices,<sup>231</sup> reasonable compliance costs, and enforcement feasibility. The customary disclosure practices, which provided the disclosure template for the securities statutes, inevitably incorporated compromises among these goals. So, too, does disclosure as it is actually practiced. This insight is not simply a matter of accurate description and persuasive justification. It has implications for specific issues, including (1) the scope of the prohibition of insider trading; (2) the scope of the implied right of action under Rule 10b-5; (3) the desirable and feasible agenda of accounting and disclosure rulemaking; and (4) the role of the SEC.

### A. Insider Trading

The debate about insider trading has focused on the question: why is insider trading prohibited? It is possible, however, to turn the question around, and ask why insider trading is permitted. The conventional position, of course, is that it is not permitted. But once it is acknowledged that an issuer's disclosures do not contain all information relevant to a correct valuation of the issuer's securities, it becomes clear that whenever insiders buy or sell they are trading with an informational advantage. Why are they permitted to do so?

A common corporate procedure is to limit trading by key management personnel to periods shortly after periodic disclosure documents have been filed and disseminated.<sup>232</sup> The theory is that during such a period an insider who trades could not be trading based on an informational advantage since the issuer has now disclosed all material information. The theory critically depends on the assumption that issuer's disclosure documents, in fact, do disclose all material information. But this is a fiction: issuer disclosure documents seldom<sup>233</sup> dis-

---

<sup>231</sup> Mahoney, *supra* note 5, argues that the disclosure requirements of the securities laws have their origin in promoter abuses that exploited limitations in common law agency doctrines and fiduciary disclosure requirements.

<sup>232</sup> See NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 309.00, at 3-4 to 3-6; Section of Business Law, American Bar Association, *Corporate Director's Guidebook-1994 Edition*, 49 BUS. LAW. 1243, 1276 (1994).

<sup>233</sup> I use the qualifier "seldom" because the activities of some issuers are so simple that there is no nonpublic information for the issuer's management to pos-

close all material corporate information. The broad definition of materiality in *Basic* combined with a prohibition of all trading while a person is in possession of material inside information is logically equivalent to a rule that key management personnel can never trade. After all, there will never be a time when key personnel are not in the exclusive possession of information, to paraphrase *Basic*, that a reasonable investor would consider important. The finding of the finance literature that trades by insiders produce an above-average rate of return supports the conclusion that insiders do trade with an informational advantage.<sup>284</sup>

Of course, the actual insider-trading cases that are brought involve trading based on information that does more than significantly alter the total mix of information available; they involve information that when released can reasonably be expected to have a significant impact on the current market price of the security. Thus this seemingly broad prohibition of trading by personnel in possession of sensitive information may reflect only the fact that the definition of materiality in *Basic* is broader than the test that in fact is applied in insider trading cases.<sup>285</sup> Perhaps the de facto definition of materiality is something narrower, more like the New York Stock Exchange's: "materially affect the market;" or the United

---

sess. An example, a closed-end unit trust holding a fixed portfolio of securities.

<sup>284</sup> H. Nejat Seyhun, *The Effectiveness of the Insider-Trading Sanctions*, 35 J. OF L. & ECON. 149, 158-167 (1992), documents the abnormal profits that insiders obtain from their transactions. See also D. Scott Lee et al., *Managers' Trading Around Stock Repurchases*, 47 J. OF FIN. 1947 (1992), the works discussed *id.* at 1959-60, and the works cited in Seyhun, *supra*, 158 n.21 and in ROBERT CHARLES CLARK, CORPORATE LAW 281, § 8.4, n.1 (1986).

<sup>285</sup> This is the conclusion of Seyhun, *supra* note 284, at 151:

Neither the shareholders nor the new statutes enacted during the 1980's seemed to provide effective additional constraints on insider trading. This evidence suggests that everyday insider trading does not fall under the definition of legally material information. Since insiders do trade on economically material information, evidence indicates that legal materiality is highly stringent.

Brudney, *supra* note 165, at 740 n.53, rejects the construction of *Basic* offered here on the ground that its results are unacceptable:

To be sure, to the extent that too expansive a definition of materiality makes the rule of 'disclose or abstain' a categorical prohibition against insiders buying or selling their corporation's securities, it may impose a wasteful cost upon society. Hence there are limits to how far the concept of material information may be expanded even for insider trading cases.

Kingdom's "information which . . . if it were made public would be likely to have a significant effect on the price of any securities."<sup>236</sup> Doubtless the scope of the actual prohibition in U.S. law will continue to be refined in case decisions; but given that trading on inside information presents a conflict of interest situation, why is not the correct legal response to prohibit trading by persons in possession of any sensitive information? Why not "just say no"? The explanation offered in the New York Stock Exchange *Listed Company Manual* is that "[m]any shareholders feel that directors and officers should have a meaningful investment in the companies they manage," but it is not explained why shareholder feelings should control, or what the connection is between these feelings and the issue of insider trading.

An advantage of share ownership by key management employees is that their ownership of shares tends to counteract the divergence in interest between the issuer and its management agents. If the key management employees have a significant part of their personal wealth in the form of the issuer's securities, it increases their interest in managing the issuer so that the securities increase in value. This is also the interest of the shareholders as a group. Thus management ownership of shares can help to overcome the divergence between ownership and control, or in the contemporary jargon, reduce agency costs.<sup>237</sup>

Management employees, however, have good reasons not

---

<sup>236</sup> Criminal Justice Act, 1933, § 56(1)(d) (Eng.). For purposes of the section "price" includes value." *Id.* § 56(3). NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL 2-4 §202.05 (continuously updated). The current United Kingdom provisions are described in Eva Lomnicka, Note: *The New Insider Dealing Provisions: Criminal Justice Act 1993, Part V*, 1994 J. BUS. LAW 173, 178. Many jurisdictions define materiality only for the purpose of insider trading, since they have no statutorily mandated form of disclosure, the required disclosure being imposed and administered by the securities exchanges. Some jurisdictions follow the American definition while others require some form of significant market impact. See Harvey L. Pitt & David B. Hardison, *Games Without Frontiers: Trends in the International Response to Insider Trading*, 55 LAW & CONTEMP. PROBS. 199 (1992). Commentators have not taken note of this distinction, probably because it is of interest only as a matter of theory. That is, as a matter of definition American law may prohibit trading on any information that would be of interest to the average investor, but there will be no enforcement proceeding or lawsuit unless the information, when released, has a significant effect on the market price.

<sup>237</sup> This advantage of share ownership by managerial employees is examined at length in Merritt B. Fox, *Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088, 2096-2106 (1994).

to hold their wealth in the form of the securities of their employer. A substantial portion of their human capital is tied up in their relationship with their employer. Diversification counsels that they should hold their financial capital so that its value is not related to the success or failure of their employer. Any natural reluctance to hold shares in the employer will be increased if assets held in that form are subject to special restrictions on the ability of the employee to buy and sell them.

The desirable scope of regulation of insider trading requires the accommodation of a conflict between the goal of preventing employees from using employer information for their own rather than the employer's benefit, or even adversely to the interest of their employer, and the goal of encouraging employee ownership of shares in the firm. The common law, the short-swing trading prohibitions of Section 16(b) of the Exchange Act,<sup>238</sup> and the judicial interpretation that makes Rule 10b-5 a prohibition of insider trading can all be seen as implementations of a common dilemma: how to draw a line between transactions in which insiders are permitted to exploit the information advantage resulting from their employment and transactions in which they are not. The line has moved over the years, but it has never been a line that has separated transactions that involve no exploitation of insider advantage from transactions that do.

This perspective might contribute to softening the righteous tone that has suffused the debate on insider trading. Under any conceivable set of rules governing insider trading there are going to be situations in which insiders can take advantage in the market of information because of their employment relationship. The issues relating to the desirable reach of the prohibition necessarily involve a complex set of practical tradeoffs among competing goals. In this debate, the argument that the fact that insider trading will tend to make market prices move in the correct direction cannot be dismissed casually on the ground that the mandatory disclosure system does a better job of furthering the same goal.<sup>239</sup>

---

<sup>238</sup> This is the approach to § 16(b) developed in Fox, *supra* note 287.

<sup>239</sup> This was one of the two desirable features of insider trading identified by Henry Manne. MANNE *supra* note 11, at 77-91. The existence of this phenomenon has been studied recently by Lisa Meulbroeck. Meulbroeck, *supra* note 11.

## B. *The Implied Right of Action Under Rule 10b-5*

It is common for sizeable movements in the price of an issuer's security to be followed by a class action under Rule 10b-5. This can be explained by the fact that the price movement creates a situation where the 10b-5 cause of action, if successful, will result in the award of a large monetary amount. Accuracy enhancement also plays a role in making such lawsuits plausible. An implication of accuracy enhancement is that if an issuer observes the disclosure requirements, the market will never be surprised, and thus large changes in price will never occur.<sup>290</sup> How is it possible that the price fell (or rose) ten percent in a day unless there was something that they knew about and didn't tell us, or they told us something that turned out not to be true? Obviously there has been a violation of the securities laws, and the only thing to do is to file a lawsuit under the securities laws and use the discovery process to find out what the violation was. If, however, securities disclosure is properly incomplete, then atypical price movements are something to be expected. The fact of the price movement alone does not suggest anything about whether or not a securities law violation has occurred.

One of the most interesting suggestions from a theoretical point of view to come out of the contemporary discussions of reform of the Rule 10b-5 cause of action is the proposal of former SEC Commissioner J. Carter Beese that a safe harbor for forward-looking statements be based on the business-judgment rule. Beese suggests that:

[T]he safe harbor would establish a principle of judicial non-inter-vention. As such, the safe harbor would protect directors and officers from judicial review of shareholder antifraud claims when forward-looking statements are made unless a plaintiff can establish a conflict, a lack of good faith, or a failure of honest and reasonable belief.<sup>291</sup>

---

<sup>290</sup> This is the logic behind the proposal of Mark L. Mitchell & Jeffery M. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, 49 BUS. LAW. 545, 548-49 (1994), to prove materiality by showing that the information, when released, is followed by price movements in the issuer's security that exhibit cumulative abnormal returns. The use of the event study methodology outlined can demonstrate that information is material even when the resulting stock price movements are relatively small.

<sup>291</sup> 1994 Concept Release, *supra* note 77, at 11. The link between the business

This proposal points in the direction of rejoining disclosure law with corporate law generally, recognizing that information is like any other corporate asset, and that decisions about when, where and how it is to be used involve difficult tradeoffs, judgments and risk taking that the courts are poorly equipped to review.<sup>292</sup>

The absence of any role for business judgment in the Supreme Court's securities law jurisprudence explains why it was so difficult for the defendants in *Basic*<sup>293</sup> to make a persuasive argument to the Court. The decisions of the Third Circuit, which held that there was no obligation to disclose merger negotiations until agreement has been reached on "price and structure,"<sup>294</sup> can be understood as decisions which drew a line between an area of disclosure policy where courts should

---

judgment rule and corporate information policy was suggested by a footnote in *Texas Gulf Sulphur v. SEC*, 401 F.2d 833, 850 n.12 (2d Cir. 1968) ("We do not suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC.") Some commentators on earlier drafts of this Article have suggested that one could read this language as recognizing a general business-judgment exception to the disclosure requirements. I believe that the correct reading is that the business judgment can only be exercised "within the affirmative disclosure requirements," i.e. that it can only apply to matters not otherwise required to be disclosed. The area in which this business judgment can be exercised has shrunk as the matters subject to affirmative disclosure requirements have expanded since 1968, particularly through the MD&A.

<sup>292</sup> This connection was obvious to Adolf A. Berle and Gardiner C. Means, writing in 1932 before corporate law and securities disclosure regulation had become separate bodies of law.

[A]ny development in the law must contemplate at least the possibility of a legal privilege in the management permitting them to withhold information where in their honest judgment it is for the best interests of all concerned; and as to this, the honesty and good faith of the management should be conclusive. In practice, honesty and good faith are frequently tested by ascertaining whether or not the management or friends and connections of it have made arrangements to profit by the disclosure or non-disclosure. Good faith will hardly be evoked where the management can be found to have profited. Bad faith will probably be difficult to prove where in fact no such profit has been made.

ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 324 (1933). Berle's view of the matter still seems to characterize corporate (as opposed to securities) law, at least in New York. See *Lindner Fund, Inc. v. Waldbaum, Inc.*, 82 N.Y.2d 219, 624 N.E.2d 160 (1993).

<sup>293</sup> *Supra* text accompanying note 158.

<sup>294</sup> *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984); *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982).

defer to management's business judgment and an area where there is insufficient justification for a management decision not to disclose. The Third Circuit stressed that once agreement on price and structure has been reached, it is less likely that disclosure of the negotiations will cause them to break down and for the public to be led to believe that a merger will occur when it is still not improbable that the negotiations will break down.<sup>295</sup> It is also the case that once agreement has been reached on price and structure, it is necessary for information about the negotiations to be shared with the much larger number of people required to prepare the implementing merger documents, and the larger number of people "in the know" decreases the chances that it will be possible to maintain the secrecy of the merger negotiations. Thus one can view the Third Circuit's "price-and-structure" bright-line test as an effort to distinguish between the time when management can decide in good faith that it is in the issuer's interest not to disclose the merger negotiations and to use literally true but incomplete statements such as "the Company is aware of no reason that would explain the activity in its stock" to avoid disclosure of the negotiations, and the time when the corporate interest in continued nondisclosure becomes so weak that management no longer has this discretion. An argument in this form would have required a Court receptive to the idea that the securities laws recognize that there is a legitimate domain for the exercise of management discretion over corporate disclosure policies. The opinion in *Basic* is the work of Justices who would not have been persuaded by an argument that depended upon this idea.

The safe-harbor concept presents the Commission with intractable choices. It is impossible to draw a coherent line between that information whose production needs to be encouraged by providing protection from liability and that information whose accuracy needs to be encouraged by imposing an exacting standard of liability. The narrower the reach of any safe harbor, the less its practical importance, as the experience with Rule 175 so clearly illustrates. The broader the reach of a

---

<sup>295</sup> "Finally, with both price and structure agreed to, there is only a minimal chance that a public announcement would quash the deal or that the investing public would be misled as to likely corporate activity." *Greenfield*, 742 F.2d at 757.



safe harbor, the more the anomaly of leaving the remaining information unprotected.<sup>296</sup> This is a contradiction at the heart of the liability scheme of the securities laws that cannot be obscured by a safe harbor, no matter how complex. Perhaps some day the Supreme Court will return to the scienter standard of *Ernst & Ernst v. Hochfelder*,<sup>297</sup> and interpret it in a way that provides more protection from liability for speech related to the value of securities than any of the safe harbors ever proposed would do only for forward-looking statements.

### C. Accounting and Disclosure Rulemaking

Changes in the rules and procedures of mandatory disclosure are costly. The thousands of persons involved in the daily administration of these rules must learn the new rules and make the necessary changes in issuer and accounting-firm procedures. If the changes reasonably can be expected to increase the social benefits of the disclosure system, then those benefits may exceed the costs. If, however, there is no standard which can be applied to judge whether there are social benefits from any proposed change, then prudence cautions against

---

<sup>296</sup> The lower courts have permitted issuers to create their own home-made safe harbor through what has come to be called the "bespeaks caution doctrine." The doctrine is based on the simple notion that statements must be read in their context, and that if forecasts, opinions or projections are accompanied by a sufficiently clear warnings, no reasonable investor would rely on them, and therefore they are not material, an amalgam of the materiality test and fraud on the market doctrine of *Basic v. Levinson*, 485 U.S. 224 (1988). See *In re Donald J. Trump*, 7 F.3d 357, 364 (3d Cir. 1993). See generally Royce de R. Barondes, *The Bespeaks Caution Doctrine: Revisiting the Application of Federal Securities Law to Opinions and Estimates*, 19 J. CORP. L. 243 (1994). But why should the doctrine be limited to only certain kinds of statements? Why can't the entire document be qualified so that no reasonable investor would rely on any of it? For instance, the 1993 ANNUAL REPORT OF CORNING, INC. states on the inside back cover: "Neither this report nor any statement contained herein is furnished in connection with any offering of securities or for the purpose of promoting or influencing the sale of securities."

<sup>297</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1975). Section 204 of H.R. 10, 104th Cong. 1st Sess., adds a new section 10A to the Exchange Act. Section 10A(a)(2) would provide that the plaintiff in an implied private action for money damages must prove "that the defendant knew the statement was misleading at the time it was made, or intentionally omitted to state a fact knowing that such omission would render misleading the statements made at the time they were made." H.R. 10, introduced January 4, 1995, titled A Bill to Reform the Federal Civil Justice System; to Reform Product Liability Law, is part of the legislative package popularly known as the contract with America.

change.

Reform is particularly problematic where the rule looks to the use of a mandatory requirement. There can be no reasoned objection to revised or improved accounting practices which the profession, or firms in the profession, develop and successfully persuade users to adopt voluntarily. No one can disagree that "[i]ndependent auditors must constantly strive the improve their services to add continuing value to the users of financial information."<sup>298</sup> That is, however, a quite different process than one where adoption is required by the law, whether or not the practice is of benefit to the user or society. If a practice does indeed add continuing value, then why do we not expect the users to adopt the practice voluntarily? And if they will not adopt the practice voluntarily, what does that tell us about its value?

The mandated nature of disclosure accounting is the reason why there is something to be said for Kripke's (and many others') arguments that disclosure accounting should be governed by the SEC, not by the accounting profession.<sup>299</sup> The accounting profession is only one party in interest in the debate about accounting standards, and accounting standards that are unduly responsive to the interests of the accounting profession in the sale of accounting services, rather than the interests of all the affected parties, are probably not socially beneficial. The rhetoric of contemporary accounting rulemaking—which focuses on the desires of user groups such as financial analysts who are asked what they would like if they do not have to pay for it, and which is implicitly embraced by the Supreme Court in *Basic*—simply ignores many considerations that are important to the social interest. At least in theory, all of the affected parties, including issuers, are more likely to have their interests considered by the SEC than by

---

<sup>298</sup> BOARD OF DIRECTORS OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, MEETING THE FINANCIAL REPORTING NEEDS OF THE FUTURE: A PUBLIC COMMITMENT FROM THE PUBLIC ACCOUNTING PROFESSION 1 (1993).

<sup>299</sup> KRIPKE, *supra* note 6, at 153: "The determination of what accounting should mean is the SEC's most important job—too important to be left to others." In the 103rd Congress Senator Joseph Lieberman introduced S. 2525 which would require that accounting standards whose use is required in documents filed under the Exchange Act be adopted by a majority vote of the SEC itself. 40 Cong. Rec 514, 478-06 (1994).

the FASB, if only because the process of appointment to the SEC is more open than that of appointment to the FASB.<sup>300</sup>

Another alternative is to leave the design of disclosure requirements to negotiation between the issuers, the underwriters, the exchanges, and where represented directly, the purchasers, requiring only that the issuer's disclosure practices be fully disclosed, and once disclosed, followed.

The most striking feature of the mandatory disclosure system as it has developed is the way in which it has suppressed variation in practice. One size fits all—large and small, debt and equity, initial public offering and continuing disclosure—and all fit only one size—there is little disclosure beyond, and in any form different from, that mandated by the Commission. An alternative form of disclosure regulation would permit issuers to choose from a range of acceptable menus, imposing only the condition that they clearly specify which menu they are choosing from.<sup>301</sup> For instance, it would

---

<sup>300</sup> The members of the FASB are appointed by the Financial Accounting Foundation, whose trustees are in turn elected by constituent professional organizations. The organizations (with the number of trustees in parenthesis) are the American Accounting Association (1), the American Institute of CPAs (4), the Financial Analysts Federation (now the Association for Investment Management Research) (1), the Financial Executives Institute (2), the National Association of Accountants (1), the Securities Industry Association (1), and various governmental accounting groups (3). Three additional trustees are selected by the trustees, for a total of 16 votes. See PAUL B. W. MILLER, *THE FASB: THE PEOPLE, THE PROCESS, AND THE POLITICS* 16 (1988). The Financial Executives Institute and the National Association of Accountants, largely composed of employees of private issuers, have three votes. If the government representatives are viewed as issuer representatives, there are six issuer votes. If the government representatives view themselves as issuer representatives only insofar as the issues affect government securities, and otherwise consider themselves regulators, then there are only three clear issuer votes. The Association for Investment Management Research and the Securities Industry Association are users, and together with the providers of accounting services and education, there are seven votes. Extensive information on the structure of the Financial Accounting Standards Board can be found in PELHAM GORE, *THE FASB CONCEPTUAL FRAMEWORK PROJECT 1973-1985: AN ANALYSIS* (1992). The problem of the conflict of interest inherent in professional control of rules and requirements applicable to others is not limited to the accounting profession. *E.g.*, Jonathan R. Macey, *Judicial Preference, Public Choice, and the Rules of Procedure*, 23 J. OF LEG. STUDIES 627 (1994). A number of readers of earlier drafts of this Article have expressed dismay at the consequences should the SEC become more deeply involved in accounting, and the FASB can be viewed as a brilliant, if jury-rigged, device to avoid just that.

<sup>301</sup> There are elements of current practice that give issuers choices as to disclosure format. An issuer who qualifies can, for instance, choose between the require-

be possible to permit a range of approaches to segmentation from no segmentation to segmentation more detailed than any now practiced with only the requirement that management disclose the segmentation practice it has chosen to follow.

A result of a one-size-fits-all disclosure system is that it suppresses any opportunity for experimentation, change and innovation in accounting and disclosure. Rather than observing particular firms successfully adopt changes in accounting procedures that are then adopted by others, any reform must be channeled through the FASB or the SEC on an all-or-nothing basis, and either adopted before it is tried or rejected without a trial.

A simple change to the SEC's disclosure regulations that would recognize the interest of the issuer in confidentiality would be additional regulations—regulations twinned to the present materiality regulations, Rules 408 and 12b-20,<sup>322</sup> that would acknowledge that managements can omit (with disclosure of their election to omit) required disclosures if they determine that the disclosure of the item "might prejudice the company's business interests."<sup>323</sup>

A possible and fundamental change would be for the Commission to abandon its present approach in which it attempts to identify and mandate the "best" practice to an approach in which it would provide issuers with a list of acceptable options from which they could choose. The Commission could include as acceptable options disclosure practices and formats that satisfy the prudent investor concept<sup>324</sup>—that is, disclosure practices that have proven acceptable to both buyers and sellers in repeat transactions.

An advantage of a change to a permissive-options ap-

ments of S-1, S-2 or S-3, or to transact under the SB Regulations, Regulation A, or Regulation D. Even more importantly, in the modern world issuers can often choose which national regulatory regime to use, which is in part a form of choosing their disclosure format.

<sup>322</sup> 17 C.F.R. § 230.408 (1995) and 17 C.F.R. § 240.12b-20 (1995), quoted *supra* page 66.

<sup>323</sup> The language is from the disclosure rules of the London Stock Exchange, as quoted in NORMAN S. POSER, *INTERNATIONAL SECURITIES REGULATION: LONDON'S "BIG BANG" AND THE EUROPEAN SECURITIES MARKETS* 247 (1991) (quoting LONDON STOCK EXCHANGE, *ADMISSION OF SECURITIES TO LISTING*, at §§ 5.03-5.10 (1937) (known as the "Yellow Book")).

<sup>324</sup> Described *supra* text accompanying notes 4-5.

proach is that the Commission could switch its focus from trying to determine and mandate the best practice, to instead identifying and preventing the use of those practices that have shown themselves to be harmful. In other words, the Commission could include on its menu of options practices which have proven attractive and useful to intelligent and capable commercial parties in repeat transactions, while prohibiting those practices that have been shown useful to those who prey with such regularity on the financial markets. For instance, the Commission might simply provide that transactions carried out and documented in accord with United Kingdom, German or Japanese requirements—to give but a few examples—satisfy U.S. requirements.<sup>305</sup> It might also provide that a financial statement certified by an accountant who has not satisfied the licensing requirements of any recognized regulatory regime does not qualify as a certified statement, or that a best-efforts underwriting in which the proceeds are not subject to escrow is not permitted.

This is an approach that could be implemented incrementally, without undertaking a systematic revision of the entire body of disclosure requirements. The SEC could simply add the permissive options approach to its regulatory methods. For instance, in connection with its current initiative

---

<sup>305</sup> Readers who are disconcerted by the thought that securities might be sold in the United States under foreign documentation should consider that such securities can already be sold in U.S. markets under Rule 144A, 17 C.F.R. § 230.144A (1995). The 144A market is open to (among others) qualified institutional buyers who in the aggregate own and invest on a discretionary basis at least \$100 million in securities. It is impossible to explain the category of eligible participants on the theory that they are the only persons who are capable of understanding non-U.S. documentation. A Japanese expatriate businessman living and working in the United States might be equally or better able to understand the documentation accompanying a security issued under Japanese documentation than the American trained executives of a large insurance company. A more likely explanation is that the firms permitted to participate in the 144A market are large enough to operate directly in non-U.S. markets. *See*, for example, Rule 902(o)(6), 17 C.F.R. § 230.902(o)(6) (1995), which excludes from the definition of U.S. person in Regulation S (providing a safe-harbor for non-U.S. public offerings from the Securities Act) "any agency or branch of a U.S. person located outside the United States . . . if (i) the agency or branch operates for valid business reasons; and (ii) the agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located."

reviewing the treatment of forward-looking statements,<sup>306</sup> it could consider addressing the problem by giving issuers a range of choices, requiring only that issuers select one, that they disclose which selection they have made, and that they provide notice when they change their selection.

## CONCLUSION

Accuracy enhancement fits nicely with the reassuring patter of the securities salesman. "Don't worry, this issuer is required under the law to disclose the information material to the correct valuation of its securities. I know you haven't had time to look at it, but our people in New York have examined it carefully and they say this is a good price." The securities salesman cannot persuade as many customers to buy or sell if he or she says, "Look, this is a shot in the dark. There is a lot that neither you nor I know about these companies. I can't really say what will happen, but my goodness, would life be any fun if we didn't take chances?" It is easy for an agency focused on the securities industry to fall into the error of equating the ability of the industry to sell securities with the health of the capital markets. But it is not only the function of investors to buy securities, it is also their function to assume and carry risk, and that is a function they will better perform if they understand that that is what they are doing. Securities salesman under any system will try to suggest that the applicable regulatory regime is one which makes the customers' decisions to transact easy, but it is not the function of the SEC, an agency whose mission is to serve the public interest,<sup>307</sup> to enhance the credibility of that suggestion.<sup>308</sup>

---

<sup>306</sup> 1994 Concept Release, *supra* note 77.

<sup>307</sup> The Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (1994), which established the SEC in § 4, provides that "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions."

<sup>308</sup> To quote Kenneth Boulding:

There is something to be said . . . for a certain naiveté and simplicity in accounting practice. If accounts are bound to be untruths anyhow, as I have argued, there is much to be said for the simple untruth as against a complicated untruth, for if the untruth is simple, it seems to me that we have a fair chance of knowing what kind of untruth it is. A known

---

untruth is much better than a lie, and provided that the accounting rituals are well known and understood, accounting may be untrue but it is not lies; it does not deceive because we know that it does not tell the truth, and we are able to make our own adjustment in each individual case, using the results of the accountant as evidence rather than as definitive information.

Kenneth E. Boulding, *Economics and Accounting: The Uncongenial Twins*, in STUDIES IN ACCOUNTING THEORY 44, 55 (W.T. Baxter & Sidney Davidson eds., 1962).