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MANDATORY DISCLOSURE THEORY AND MANAGEMENT PROJECTIONS: A LAW AND ECONOMICS PERSPECTIVE

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I. INTRODUCTION

This article examines the debate over the utility of the Securities Exchange Commission's (SEC or Commission) mandatory disclosure of management information by examining proposals to expand that system to require disclosure of management forecasts and valuation judgments. Whether the present system of mandatory disclosure, or an expanded version, is in the interest of investors turns on a series of related questions. First, does the current mandatory disclosure system create useful information, otherwise unavailable, or other benefits such as reduced information collection costs for market professionals or investors generally? Second, do the benefits of governmental intervention outweigh the costs of the regulatory system created by mandatory disclosure? Third, would required periodic or transaction-oriented disclosure of management forecasts and valuation judgments change the calculation of benefits and burdens of mandatory disclosure?

To explore these questions, I first review the history of SEC and court regulation of disclosure of "soft" forward-looking information and outline the current state of the law on disclosure of forecasts and valuation judgments as it exists in different contexts. I then discuss the debate in the law and economics literature concerning the utility of mandatory disclosure in general and of forecast disclosure in particular. Finally, I propose a rule that would mandate management disclosure of earnings and valuation judgments when control transactions are pending.

II. HISTORY OF THE REGULATION OF MANAGEMENT DISCLOSURE OF FORWARD-LOOKING INFORMATION

Traditionally, the SEC took a highly negative position on the disclosure of soft information such as projections and appraisals.¹

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1. The court in *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973), summarized the basis of the SEC's policy. The policy against the inclusion of projections

The Commission believed that this information was unreliable, subject to manipulation by management, and would be given undue weight by investors.² Thus, the Commission did not permit such information in SEC-filed documents.³ The SEC did, however, allow issuers to disclose soft data in informal communications with analysts or in press releases.⁴ As a consequence of the Commission's policy, courts have traditionally refused to hold companies liable for failing to disclose projections and appraisals.⁵

Beginning in the 1970s the Commission began to change its attitude toward disclosure of soft information in mandated filings.⁶

or appraisals in proxy statements or other mandated-disclosure documents stemmed from a deep distrust of their reliability, a concern that investors would rely too heavily on such appraisals, and a belief that the Commission's staff would not be able to check authenticity reliably. *Id.* at 1294. For a comprehensive history of the development of SEC policy on disclosure of projections and appraisals, see Brown, *Corporate Communications and the Federal Securities Laws*, 53 GEO. WASH. L. REV. 741 (1985); Comment, *The SEC Safe Harbor For Forecasts—A Step in the Right Direction*, 1980 DUKE L.J. 607. See also Schneider, *Soft Information Disclosures: A Semi-Revolution*, 1984 INST. ON SEC. REG. 19; Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254 (1972). As used by most commentators, the term "soft information" covers data that is not factual in the narrow sense, such as a prediction of future value or future earnings.

2. See Guidelines for the Release of Information by Issuers, Securities Act Release No. 5180, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,192, at 80,578 (Aug. 16, 1971) ("Any publication by a company in registration should be limited to factual information and should not include such things as projections, predictions, forecasts or opinion with respect to value.").

3. The earliest SEC proceedings permitted inclusions in registration statements of earnings and future valuation predictions if made with a reasonable basis. In the Matter of Ypes Cadillac Mines, Ltd., 3 S.E.C. 41 (1938); In the Matter of American Kid Co., 1 S.E.C. 694 (1936). Thereafter, a firm Commission policy developed, precluding such statements in both registration statements and continuous disclosure documents. In the Matter of Thomas Bond, Inc., 5 S.E.C. 60 (1939); SEC, DISCLOSURE TO INVESTORS, A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 96 (1969) [hereinafter the Wheat Report]. See also Comment, *Fearless Forecasts: Corporate Liability for Earnings Forecasts That Miss the Mark*, 16 B.C. IND. & COM. L. REV. 115, 116-17 (1974).

4. As early as 1966, between 25% and 33% of widely held companies released, in some manner, earnings projections to the financial press. Other firms affirmatively communicated this information to securities analysts on an informal basis, while almost all firms would respond in some form to analysts' queries on the subject. The only limitation on these types of communications occurred when a firm was in registration under the 1933 Act. See Comment, *supra* note 3, at 118. However, another study states that only approximately 10% of firms presently publicly disclose earnings projections. See F. LEES, PUBLIC DISCLOSURE OF CORPORATE EARNINGS FORECASTS (Conference Board, 1981).

5. See, e.g., *Radol v. Thomas*, 772 F.2d 244, 253 (6th Cir. 1985); *South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co.*, 669 F.2d 1265, 1271 (9th Cir. 1982); *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1221-22 (9th Cir. 1980); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 292-93 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

6. The change in the Commission's position in the 1970s followed the filing of its

The Commission recognized that forward-looking data was perhaps the most useful type of information for investors.⁷ Moreover, the Commission's traditional policy exacerbated the problem of selective disclosure to favored analysts. This put unsophisticated investors, intended beneficiaries of the no-disclosure rule, at a potential competitive disadvantage.⁸ The Commission therefore promulgated a series of releases and a safe-harbor rule, which were designed to encourage the use of projections.

The SEC held hearings in 1972 on the use of projections.⁹ Following these hearings, the Commission issued a release that allowed the use of projections in 1933 Act¹⁰ registration statements and in 1934 Act¹¹ continuous disclosure documents as long as the projections were made in good faith and with a reasonable basis.¹² Subsequently, the SEC proposed rules governing the preparation of projections.¹³ Issuers severely criticized the proposed rules, particularly the requirement to update and disclose the assumptions behind the projections.¹⁴ Finally, in 1979 the Commission adopted its current safe-harbor rule concerning projections.¹⁵ In large part the

amicus brief in *Gerstle v. Gamble-Skogmo, Inc.*, 478 F. 2d 1281 (2d Cir. 1973), which asserted that a merger proxy statement could be materially misleading if it did not disclose asset appraisals when the appraisals were substantially different than book value. The Second Circuit rejected this position, primarily because it was a substantial departure from the Commission's past practice.

7. Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,211, at 82,667 (Feb. 2, 1973).

8. To the extent that the practice is widespread, the disclosures made to analysts are, in effect, to the market as a whole.

9. In the Matter of Estimates, Forecasts or Projections of Economic Performance, Exchange Act Release No. 9844, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,075 (Nov. 1, 1972).

10. 15 U.S.C. §§ 77a-77kk (1982).

11. 15 U.S.C. §§ 78a-78mm (1982).

12. Guides for Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5992, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,756 (Nov. 7, 1978). Disclosure of such information remained voluntary, as did disclosure of the assumptions behind a projection. The SEC warned issuers, however, to correct projections that had become outdated. Selective tipping of a projection to favored analysts, for example, would be subject to Commission scrutiny under the rules against insider trading.

13. Proposed Rules on Earnings Projections, Securities Act Release No. 5,581, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,167 (Apr. 28, 1975).

14. Earnings Projections and Rule 14a-9 Amendment, Securities Act Release No. 5699, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,461 (Apr. 23, 1976).

15. Safe Harbor Rule for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117 (June 25, 1979) (adopting SEC rule 175, 17 C.F.R. § 230.175 (1986)). The safe harbor protects forward-looking statements made in continuous disclosure documents, annual reports used in the proxy solicitation

rule codifies existing Commission policy and court rulings on projections.¹⁶ Projections remain protected from attack if they are made in good faith and with a reasonable basis. The plaintiff has the burden of establishing that a projection did not meet this standard of care.¹⁷ The Commission did not, however, require disclosure of assumptions behind a projection, although it did remind issuers that failure to disclose assumptions might render a particular projection materially misleading.¹⁸ In addition, the Commission left the issue of updating to case-by-case development rather than rule, but alerted issuers to a general duty to update for changes regarding assumptions or operations.¹⁹

The Commission's activities in this area have led to considerable confusion in the recent case law on when issuers or others might be required to disclose projections or appraisals. Most courts begin their analysis by noting the Commission's earlier hostility to disclosure of soft data and its subsequent decisions not to mandate such disclosures.²⁰ Some courts simply end their analysis here, with the broad conclusion that projections are not material.²¹ Other courts have concluded that reasonably certain projections may indeed be

process, proxy statements, and registration statements. The rule also protects forward-looking statements made outside an SEC filing if the firm reaffirms them in a subsequent filing. The rule defines forward-looking statement to include projections of revenue, earnings, capital expenditures, and statements of management plans and objectives. The safe harbor also protects a disclosed assumption behind any protected, forward-looking statement.

16. Brown, *supra* note 1, at 800. A leading case which might be read to present a more stringent test of liability for forward-looking statements is *Beecher v. Able*, 374 F. Supp. 341 (S.D.N.Y. 1974). *Beecher* involved the registration of debentures of Douglas Aircraft. The prospectus stated: "It is very likely that the net income, if any, for fiscal 1966 will be nominal." *Id.* at 346. The court construed the statement to mean that the company believed there would be no substantial loss as well as no substantial gain. *Id.* at 347. The company in fact lost \$52 million. *Id.* at 344. With respect to the risk of loss, the court stated that Douglas would be liable under § 11 of the 1933 Act unless the company based the forecast on facts from which a reasonably prudent investor would conclude that it was highly probable that the forecast would be realized. *Id.* at 348. The court also held that the firm must disclose the assumptions underlying the projection if their validity is in doubt. *Id.*

17. Securities Act Release No. 6084, *supra* note 15, at 81,940.

18. *Id.* See also Securities Act Release No. 5992, *supra* note 12.

19. Securities Act Release No. 6084, *supra* note 15, at 81,943. See *Marx v. Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974) (holding an issuer liable for failing to update a projected development schedule for a new product).

20. See, e.g., *Harkavy v. Apparel Indus.*, 571 F.2d 737, 741 (2d Cir. 1978); *Resource Exploration v. Yankee Oil & Gas, Inc.*, 566 F. Supp. 54, 63 (N.D. Ohio 1983).

21. See, e.g., *Freeman v. Decio*, 584 F.2d 186, 199-200 (7th Cir. 1978). Some courts still make the same argument with respect to appraisals. See *Pavlidis v. New England Patriots Football Club, Inc.*, 737 F.2d 1227, 1236 (1st Cir. 1984); *South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co.*, 669 F.2d 1265, 1271-72 (9th Cir. 1982).

material but, except in the context of insider trading cases, remain reluctant to find liability for a failure to disclose.²²

As in other areas of corporate law, the boom in control transactions has forced several courts to rethink the issue of required disclosure of projections or appraisals.²³ Three recent courts of appeals cases raise the issue of whether a firm must disclose soft information while a control transaction is pending. Each case creates an apparently different standard to be applied in determining whether a duty to disclose exists. The Third Circuit stated an expansive duty to disclose in *Flynn v. Bass Brothers Enterprises*.²⁴ Bass Brothers, the controlling shareholder of National Alfalfa, made an any-and-all tender offer for the remaining minority shares of National. While Bass Brothers did disclose that the assets of National were potentially worth substantially more than book value and that on liquidation National might be worth more than the tender offer price, Bass Brothers did not disclose that it had a third-party appraisal that valued the assets well in excess of the market price and offering price for National. Measured against the standards of disclosure that existed in 1976, the specific holding of the case was that Bass Brothers did not have to disclose the appraisal.²⁵ The court

22. See, e.g., *Goldman v. Belden*, 754 F.2d 1059 (2d Cir. 1985); *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8 (2d Cir. 1977); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *Alaska Interstate Co. v. McMillian*, 402 F. Supp. 532 (D. Del. 1975). Cf. *In re Digital Equip. Sec. Litig.*, 601 F. Supp. 311 (D. Mass. 1985) (denying summary judgment when affidavits raised factual issue concerning potential knowingly false projection).

23. In recent years there has been an unprecedented number of mergers, hostile tender offers, going-private transactions, repurchases, and recapitalizations (so-called control transactions).

24. 744 F.2d 978 (3d Cir. 1984). For detailed commentary on *Flynn*, see Comment, *Mandatory Disclosure of Soft Information in the Market for Corporate Control*, 35 EMORY L.J. 213 (1986). As the commentator observes, the *Flynn* court does not discuss when the duty to speak arises. When an outsider makes an information discovery and then makes a tender offer based on that discovery, one can make a persuasive case for no duty to speak. This protects the discovery value and encourages production of new information. The duty to disclose plans and proposals under the Williams Act limits this ability to withhold. Thus, a firm must disclose a plan to liquidate, as well as the basis of the plan. Without specifically so holding, it appears the court deemed Bass Brothers to be an insider with a duty to speak. See also Note, *A Hard Look at Soft Information*, 16 SETON HALL L. REV. 511 (1986); Note, *Target Corporation Disclosure of Soft Information in Tender Offer Contests*, 54 FORD. L. REV. 825 (1986) [hereinafter Fordham Note].

25. Because of the evolution of SEC disclosure policy since 1976, the Third Circuit concluded under the facts of the specific case that it would be unfair to apply contemporary disclosure standards. Rather, it decided the case under the law as it existed in 1976. 744 F.2d at 988. The district court had directed a verdict for Bass Brothers because it believed that the appraisal was not based on sufficient information. The appellate court stated that the result of the case might well have been a case for the jury. *Id.* at 991 n.22.

found that the report was not prepared in connection with the tender offer, nor was it prepared by expert appraisers.²⁶ Thus, the court held that the report did not have sufficient indicia of reliability to require disclosure.

More significant than the actual holding of the case is the test set out by the *Flynn* court. The court attempted to define when soft information is material under the *TSC Industries* "total mix" test.²⁷ Therefore, courts in the Third Circuit will have to determine on a case-by-case basis whether soft information should be disclosed. Under the *Flynn* test, courts must weigh the information gains to be derived from disclosure against the potential harm from disclosure, such as investors' undue reliance on the data.²⁸ In striking the balance, the factors a court should consider include: the expertise of the report preparer; the purpose for which the report was prepared; the availability of the data from other sources; and the degree of subjectivity reflected in the report's preparation.²⁹ Although not worked out in any detail, the thrust of this test is to mandate disclosure in some instances in which the prior case law would have permitted nondisclosure. If the corporate decisionmaker used the report in connection with the transaction, disclosure would often be required. The *Flynn* test also balances the importance of the information against the uncertainty of the outcome.

*Starkman v. Marathon Oil Co.*³⁰ and *Radol v. Thomas*³¹ present the question of whether an offeror or an offeree must disclose asset appraisals and earnings projections in connection with competing tender offers. The Sixth Circuit held the specific reports to be im-

26. *Id.* at 989. The report was prepared so that a third party could obtain acquisition financing for a planned purchase of National, although it is also possible that Bass Brothers itself relied on the report for its business decisions concerning National.

27. *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976):

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his [or her] vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

28. 744 F.2d at 988. Courts must also balance the importance of the information against the uncertainty of the outcome.

29. *Id.*

30. 772 F.2d 231 (6th Cir. 1985).

31. 772 F.2d 244 (6th Cir. 1985).

material as a matter of law. According to the court, soft information must be disclosed depending on the certainty of the underlying data.³² The court rejected the *Flynn* test, believing that the balancing approach was too uncertain and unpredictable. Furthermore, the court believed that, at least in the tender offer context, the market would produce soft information through competing tender offers.³³ Thus, future-oriented information is material in the Sixth Circuit only if "substantially certain to hold."³⁴

This standard leaves few, if any, instances in which soft information is deemed sufficiently certain to require disclosure. By definition, the standard projection or appraisal is speculative and uncertain.³⁵ Thus, the Sixth Circuit has held that cash-flow and earnings projections prepared for use in a selling document and interim earnings reports are sufficiently uncertain.³⁶ Under the test, the Sixth Circuit has consistently refused to require disclosure of soft information.

*Walker v. Action Industries*³⁷ presents the Fourth Circuit's view on the necessity of disclosing income and sales projections in the context of an issuer self-tender. The duty to speak here is clear under a fiduciary duty/insider trading analysis. As to the question of materiality, the precise test adopted by the Fourth Circuit is difficult to ascertain. The court did state that "[w]e do not hold that there is no duty to disclose financial projections under any circumstances."³⁸ However, it rejected a duty to disclose in the particular case because it considered the uncertain nature of the specific projections significant.³⁹ Furthermore, the court stated that "we believe that a further

32. *Starkman*, 772 F.2d at 241.

33. Although not stated in law and economics terms, this represents the notion of self-induced disclosure. The target would release positive soft-information in an effort to fend off a raid. The court did not consider the situations in which management conflicts would create incentives to withhold information.

In addition, the court discouraged the disclosure of uncertain soft data by requiring disclosure of "the basis for and limitations on the projected realizable values." 772 F.2d at 241. This goes beyond the SEC's statements that require disclosure, in some situations, of the basis for a projection or appraisal when needed to avoid the projection's being deemed materially misleading.

34. *Radol*, 772 F.2d at 253.

35. As Brown, *supra* note 1, at 789-99 n.257 states, absent hindsight it would be difficult to establish that any projection is substantially certain.

36. *Biechele v. Cedar Point, Inc.*, 747 F.2d 209, 216 (6th Cir. 1984); *James v. Gerber Prods. Co.*, 587 F.2d 324, 327 (6th Cir. 1978); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 421 (6th Cir. 1974).

37. 802 F.2d 703 (4th Cir. 1986).

38. *Id.* at 710.

39. *Id.*

transition from permissive disclosure to required disclosure should be occasioned by congressional or SEC adoption of more stringent disclosure requirements for financial projections, rather than by courts."⁴⁰ The court relied on the fact that the SEC had no specific requirement to disclose this particular data in the self-tender rules.⁴¹ Finally, the court expressed concern that creating an obligation to disclose soft information would place issuers at undue risk of liability, even with the safe harbor, if the prediction turned out incorrect.⁴² These SEC rule-based reasons would apply to all projections, regardless of their certainty. It seems, then, that the Fourth Circuit might not even undertake the minimal-certainty scrutiny required by the Sixth Circuit.⁴³ The Fourth Circuit approach leads to the conclusion that under the current state of the law, corporations need not disclose any projections.

State courts have faced the similar issue of whether failure to disclose a projection during a control transaction violates state law duties of care and loyalty. The Delaware Supreme Court opinion in *Rosenblatt v. Getty Oil Co.*⁴⁴ is a typical case. The case involved a parent-subsidary merger in which the minority shareholders of the subsidiary received securities of the parent as consideration.⁴⁵ During the pendency of the transaction the parent prepared a routine projection that showed a decline in earnings for the next fiscal year.⁴⁶ Yet the court stated that the nondisclosure did not violate any state law duty, primarily because the projection was not specifically prepared in connection with the merger transaction and because the court believed that disclosure of the projection would not have affected the negotiations over the exchange ratio.⁴⁷ The court's belief that disclosure would not have affected negotiations, however, cannot be correct. A decline in the parent's earnings would be reflected in the value of the parent's stock, and thus would adversely affect the exchange ratio for the merger transaction. Whatever valuation model is used, to the reasonable investor such

40. *Id.* at 709.

41. *Id.*

42. *Id.* at 710.

43. In fact, the court declined to "specifically adopt any of the various positions held by the other circuits regarding whether a duty exists to disclose financial projections." *Id.* at 709 n.11.

44. 493 A.2d 929 (Del. 1985). In determining that the earnings projection was not material under the state law complete-candor test, the Delaware Supreme Court claimed that it was using the federal total-mix test of materiality. *Id.* at 944-45.

45. *Id.* at 931.

46. *Id.* at 938.

47. *Id.* at 939.

information would be material. Moreover, for two reasons there is no question concerning a duty to speak. There was a pre-existing fiduciary relationship between the parent and subsidiary, and the information was material inside information affecting the decision on how to vote. The court nonetheless held that projections of this sort are not facts that need to be disclosed under the Delaware requirement of complete candor in parent-subsidiary mergers.⁴⁸

Thus, under both federal and state law—even after the SEC's change in policy toward disclosure of forward-looking data—there is a considerable reluctance to require disclosure of such information. No court has yet held a firm liable under any of the articulated tests for nondisclosure. Some courts even appear to go so far as to say that no firm will ever be liable for such nondisclosure in the absence of further rulemaking on the part of the SEC or new legislation.

III. THE DEBATE CONCERNING THE UTILITY OF MANDATORY DISCLOSURE

The first thirty years of federal regulation of the securities markets saw little debate concerning the theoretical underpinnings of the SEC's work. The conventional wisdom was that mandatory disclosure significantly improved the quality and quantity of management disclosure and that mandated disclosure stood as the bulwark against securities fraud.⁴⁹ However, for the past twenty years academics, using the law and economics perspective, have vigorously debated the utility of SEC-mandated disclosure. This debate is part of a more general reassessment of the utility of governmental regulation when a market-based solution might be available.⁵⁰ The debate over the limits of securities regulation has been particularly intense as additional scholars apply modern financial theory to issues of securities regulation.⁵¹

Until the regulatory-reform revisionists focused on the SEC, there was a widely held consensus that mandatory disclosure was necessary because the market would not naturally produce suffi-

48. *Id.*

49. Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1979). Professor Seligman is the leading historian of the development of the federal securities laws.

50. See generally Breyer, *Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform*, 92 HARV. L. REV. 547 (1979).

51. The efficient market model is the starting point for the analysis of securities regulation problems for those using the law and economics perspective. The implications of viewing the securities markets as highly efficient information processors are discussed *infra* notes 56-57, 71, 73-81, and accompanying text.

cient, truthful information concerning issuers.⁵² Furthermore, mandatory disclosure was a significant deterrent to fraud. The revisionist critique of the SEC's work started in 1964 with the work of George Stigler.⁵³ In a classic of regulatory-reform literature, Stigler attempted to measure empirically the benefits of mandatory disclosure and weigh those benefits against the costs of SEC regulation. Stigler examined the returns of investors in new issues, both before and after the passage of the 1933 Act. He concluded that, while the Act may have reduced the volatility of investors' returns, there was no statistically significant evidence that its passage actually enhanced investors' returns. Stigler believed these results showed that the costs of compliance did not outweigh any benefits arising from the Act. The reduction of volatility in new-issue prices only demonstrated that the cost of compliance excluded smaller, untested issuers from the public capital markets. In a later study of new issues, Professor Gregg Jarrell produced similar results.⁵⁴

A parallel empirical challenge was also made to the utility of the continuous disclosure requirement mandated by the 1934 Act. Professor George Benston studied the market's reaction to the passage of the 1934 Act and concluded that investors did not respond positively to enhanced mandatory continuous disclosure.⁵⁵ Arguments based on the efficient market model buttressed these empirical studies. Securities prices generally reflect all publicly available information concerning the firm.⁵⁶ The security's price promptly reflects new information. Much of what is contained in SEC-mandated disclosure forms is not new information, so disclosure is arguably irrelevant to investor judgments on risk and return.⁵⁷

The statistical studies criticizing mandatory disclosure have been challenged on both methodological and theoretical grounds. Commentators have attacked the experimental design of the studies and the inferences they drew, even if statistically accurate.⁵⁸ Sup-

52. Seligman, *supra* note 49, at 2.

53. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964).

54. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J.L. & ECON. 613 (1981).

55. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973).

56. For a leading current description of the efficient market model, see Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

57. Wolfson, *A Critique of the Securities and Exchange Commission*, 30 EMORY L.J. 119 (1981).

58. Professor Seligman comprehensively describes and evaluates these critiques. See Seligman, *supra* note 49. See also Friend & Westerfield, *Required Disclosure and the Stock Market*, 65 AM. ECON. REV. 467 (1975).

porters of mandatory disclosure have also suggested that the reduction in variance of investor returns shows an investor benefit from disclosure.⁵⁹ Moreover, recent scholarship has raised doubts about whether any time-series⁶⁰ empirical work can provide information in a fundamental way on the question of benefits arising from mandatory disclosure.⁶¹ Central changes in the securities markets limit the usefulness of all historical data. Thus, the growth of securities' analysis and institutional investing plus the elimination of fixed commissions make comparisons across time problematic.⁶²

The more current revisionist scholarship on mandatory disclosure discusses the topic from a theoretical perspective. A significant school of thought suggests that mandatory disclosure is unnecessary because firms have sufficient incentives, even in the absence of regulation, to produce an optimal amount of information concerning themselves.⁶³ The market will receive confirmation of released information through the firm's dividend policy, managerial ownership of shares, and debt issuance. With regard to information itself, investors will insist on transaction and continuous disclosure in the initial sale of the securities and to ensure an adequately liquid aftermarket. Managers will comply in order to maintain the price of the firm's shares, not only in one-shot transactions, but also to ensure repeat access to the capital markets. The incentives for liquidity-based disclosure are further enhanced when firms compensate

59. Friend & Herman, *Professor Stigler on Securities Regulation: A Further Comment*, 38 J. Bus. 106 (1965).

60. Time-series studies use stock market price movement data to measure the effect of regulation on securities prices. These studies assume that the stock market is highly efficient and that, if regulation is beneficial, the benefits will be reflected in positive price movements.

61. Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 719-21 (1984). Professor Coffee provides a complete survey of the economic arguments for and against a mandatory disclosure system. I use his article as a framework for assessing the debate concerning the utility of mandatory disclosure.

62. In 1975 fixed commissions on securities transactions were eliminated, leading to reduced transaction costs for market trades. This may have reduced the incentive for some market professionals to collect data while at the same time increasing investor incentives to exploit smaller potential disparities between the current market price and a future price that reflects new information.

63. E.g., Diamond, *Optimal Release of Information by Firms*, 40 J. FIN. 1071 (1985) (suggesting that firms may voluntarily disclose in order to increase firm value *ex ante*, because such disclosure reduces information collection costs and improves risk-sharing). See also Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673-77 (1984) (suggesting that mandatory disclosure may be needed to buttress voluntary disclosure because of the risk of insular state shareholder protective legislation and third-party competitive effects, reducing the incentives for self-induced disclosure).

managers with stock or stock-based packages, thus tying management's personal wealth to firm performance.⁶⁴ These factors create a community of interest between managers and shareholders despite the separation of ownership and control.⁶⁵

Even though there are incentives to disclose, there are significant countervailing, residual agency costs as well. Disincentives for voluntary disclosure exist, which means that the community of interest between managers and shareholders is incomplete.⁶⁶ Without disclosure the opportunity for insider trading would be marginally greater.⁶⁷ Moreover, there are natural disincentives to voluntary disclosure of negative information. Nondisclosure of adverse information may not only preserve the value of a manager's personal portfolio but also reduce the likelihood of a hostile takeover bid. Furthermore, managers may withhold information until they can correct negative outcomes. Concerns over the disclosure of negative information are also supported by empirical evidence. The evidence is particularly strong with respect to soft data. Managers delay disclosure of negative information until it becomes inevitable.⁶⁸ Positive soft information, such as an earnings projection, is often disclosed by informal means, while soft negative information is rarely disclosed quickly.

In addition, mandatory disclosure might force the disclosure of good news, news that might not be released if managers were contemplating a self-tender or leveraged buyout.⁶⁹ These disincentives

64. Publicly traded corporations routinely compensate executives based on firm performance as reflected in stock prices. F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 35-37 (2d ed. 1980). At least with respect to good news, executives have considerable incentives for firm-specific disclosure.

65. The theory thus would imply that the agency costs with respect to disclosure are zero. On agency costs, see Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

66. Coffee, *supra* note 61, at 737-43 (1984). Mandatory disclosure also reduces third-party effects. See Easterbrook & Fischel, *supra* note 63, at 685-87, 697. See also *infra* notes 78-79 and accompanying text.

67. The effect of mandatory disclosure on the opportunity for insider trading may be marginal. Mandatory disclosure filings are sufficiently episodic that much insider trading can occur long before a filing is necessary. But at the margin there may be instances in which a mandatory duty to disclose reduces the opportunity for insider trading, particularly if the information needs to be disclosed in form 8-K.

68. Pastena & Ronen, *Some Hypotheses on the Pattern of Management's Informal Disclosures*, 17 J. ACCT. RES. 550 (1979).

69. Coffee, *supra* note 61. Because many managers perceive their long-run interest as remaining in control of a public corporation, however, managers tend to reveal soft positive information while suppressing soft negative information. There is some self-induced disclosure, but the process is far from optimal. See Pastena & Ronen, *supra* note 68.

to disclosure exist, in large part, because of the dynamic nature of the present market for corporate control. As a consequence of this market, managers may not believe that they will be repeat players in the capital markets, at least with respect to their current firm. Both in good- and bad-news situations this may lead, in the absence of mandatory disclosure, to less than optimal, self-induced levels of disclosure.⁷⁰

A related critique of mandatory disclosure suggests that the efficient market makes government regulation irrelevant, and thus needlessly costly. Securities prices reflect the information contained in mandated-disclosure documents often long before filing.⁷¹ Therefore, whether the information in SEC documents is voluntarily released by issuers or ferreted out by securities analysts, it is simply not news. Eliminating mandatory disclosure will thus not affect the amount of information available to investors, but will reduce issuer compliance costs.

This attack on mandatory disclosure can be challenged on a variety of levels. First, mandatory disclosure may enable investors to measure the risk level of their portfolios more efficiently.⁷² Second, firm-specific information, revealed in mandatory disclosure documents, can be useful to professional traders even if the new-information content of the disclosure document is not substantial. Particularly as the stock markets become more dominated by professionally managed trading, an understanding of the role of securities analysts is essential to an understanding of the policy implications of disclosure through an efficient market. Even though markets are highly efficient, it may be a rational investment strategy to use a securities analyst to collect and evaluate information.⁷³ Sufficient noise exists in the price-signalling mechanism so that investors at least appear to earn an ordinary return from an investment in the services of analysts.⁷⁴ In determining an investment strategy these

70. Coffee, *supra* note 61.

71. See, e.g., Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 387 (1970).

72. Coffee, *supra* note 61, at 724; Gordon & Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761 (1985); Pozen, *Money Managers and Securities Research*, 51 N.Y.U. L. REV. 923 (1976).

73. Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission*, 13 HOFSTRA L. REV. 127, 140-44 (1984).

74. Bjerring, Lakonishok & Vermaelen, *Stock Prices and Financial Analysts' Recommendations*, 38 J. FIN. 187 (1983). The use of analysts in efficient securities markets creates an apparent paradox. Analysts are the engines of market efficiency. They collect information and evaluate it, and either directly or indirectly communicate the information to the market through the price-signalling mechanism. Yet if analysts' efforts create complete

analysts use the widest available data sets. Mandatory disclosure documents are part of the information used.⁷⁵ At a minimum, analysts can use these documents to compare and verify other data. The availability of mandatory disclosure reduces the costs of verification.⁷⁶ Furthermore, the SEC's creation and expansion of a centralized source of data reduces the social waste of analysts' duplication of each other's efforts.⁷⁷ Because the analyst industry is competitively structured,⁷⁸ these cost savings should ultimately inure to the benefit of investors generally. At the same time, some issuer disclosure costs are reduced. An issuer may be competitively injured by the disclosures it has to make. However, the competitive gains achieved by access to the disclosures of other firms ameliorates these costs.⁷⁹

A third theoretical insight suggesting that mandatory disclosure has value relates to the public-goods nature of information. A public good is one that the first user, usually the payor for the good, does not consume. Moreover, the first consumer cannot exclude other users from obtaining the benefit of the good.⁸⁰ This gives subsequent users a free ride on the first user's expenditures to produce the good. The free-riding problem reduces the incentive of first users to produce the good for others. Consumers will under-produce the good as they naturally decide to be free-riders rather than payors, creating benefits for others.

Securities research—whose product is information and analysis—meets the criteria of a public good. Because all users of the product do not pay for its use, the product can be underprovided. Mandatory disclosure can partially solve this problem. Mandatory disclosure documents are particularly useful to analysts, if only because such documents enable an analyst to verify data obtained elsewhere. By reducing the costs for analysts, mandatory disclosure

market efficiency, analysts should not earn returns sufficient to compensate them for search costs. Thus, there is no incentive for investors to use their services. If the market contains sufficient noise, though, investors can receive positive returns by using analysts.

75. The amount of use may vary on how closely a firm is followed. For the less-followed securities traded in the over-the-counter market, the information content of mandatory disclosure documents may be greater than with an actively-followed New York Stock Exchange firm.

76. Gilson & Kraakman, *supra* note 56, at 602-05.

77. Coffee, *supra* note 61, at 733.

78. The number of firms in the industry and the lack of barriers to entry show that the industry does meet these structural criteria.

79. Walker, *Forecast Disclosure: An Information Economics Perspective*, 12 J. BUS. FIN. & ACCT. 355 (1985).

80. Coffee, *supra* note 61, at 725.

shifts some of the cost of research to issuers (and then to all investor-users, reflected in the cost of capital). Moreover, analysts are particularly efficient users of the data, because they have economies of scale in data evaluation.⁸¹

Thus, even without strong empirical evidence supporting the mandatory disclosure requirements, one can make a good case that mandatory disclosure provides benefits for investors. Self-imposed disclosure may not produce sufficient information concerning issuers. Mandatory disclosure, on the other hand, can increase the stock of relevant information while reducing collection costs and solving the problem of free-riding on the securities research of others. Economy-wide disclosure also reduces the possibility that competitive injury will arise as a consequence of firm-specific disclosure.

IV. MANAGEMENT PROJECTIONS IN THE CONTEXT OF THE MANDATORY DISCLOSURE DEBATE

The primary content of mandatory disclosure documents has traditionally been historical data.⁸² Since historical data is only suggestive of future performance,⁸³ many critics of the current structure of SEC-required disclosure argue that mandatory disclosure should be refocused on future-oriented information such as earnings projections.⁸⁴

The debate over disclosure of projections has focused on three issues. The first is whether management projections actually contain new information so that access to such information would improve investor welfare. If such predictions do contain new

81. Information in a single mandatory disclosure document, when combined with other data known to the analyst, can be used to evaluate the securities of several issuers. This spreads the cost of data evaluation across several securities and is a consequence of industry-wide effects on specific firms.

82. The exception is in the area of going private transactions under SEC rule 13e-3. 17 C.F.R. § 240.13e-3 (1986). The issuer must file a disclosure statement under the rule if the result of the transaction reported is the termination of continuous reporting obligations under the 1934 Act. Schedule 13e-3 requires management to discuss its opinion concerning the fairness of the transaction and the reasons for its opinion. This obligation can force the disclosure of third-party appraisals.

83. H. KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 24-31 (1979); Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254 (1972).

84. E.g., Kripke, *A Search for a Meaningful Securities Disclosure Policy*, 31 BUS. LAW. 293, 314-16 (1975); Note, *Disclosure of Future-Oriented Information Under the Securities Laws*, 88 YALE L.J. 338, 351-53 (1978). In this context I view projections and appraisals as equivalent. See *infra* notes 132-35 and accompanying text.

information, management's future-oriented disclosures would provide useful information that is of predictive value. Such disclosures also could provide useful data for investors to test the planning and predictive abilities of firm managers. Such an ex post facto comparison with actual firm results would reveal information about the likely quality of managers' future decisions.⁸⁵ Arrayed against these potential informational benefits is the potential harm that some investors would overemphasize the informational content of management's disclosures, leading to market distortions or injuries to unsophisticated investors.⁸⁶

Second, would mandatory disclosure of management projections positively or adversely affect the firm (and its investors) in ways unrelated to the informational content issues? A potential benefit is the reduction of selective management disclosure of projections that gives the recipient a potential trading advantage.⁸⁷ 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. Moreover, required disclosure of projections might increase securities law liability risks for issuers. Other potential costs of this type of increased mandatory disclosure stem from possible responses of management to the requirement. Managers may alter their decisions in ways detrimental to shareholders so that outcomes more closely correspond with predictions. This could occur because now a missed projection would signal very bad firm performance, similar to the signal currently sent by a missed dividend.⁸⁸ Additionally, managers may manage their reported earnings to make them correspond with a previously announced forecast.⁸⁹

The third issue concerns the question of institutional choice. As with the more general question of the utility of any mandatory disclosure system, one must ask whether an unregulated market system produces optimal disclosure of projections or is regulatory intervention necessary to reach an optimal solution. Managers may have an incentive to disclose future-oriented information volunta-

85. Dev, *Problems in Interpreting Prospectus Profit Forecasts*, 3 ACCT. & BUS. RES. 110 (1973).

86. Comment, *Mandatory Disclosure of Corporate Projections and the Goals of Securities Regulation*, 81 COLUM. L. REV. 1525, 1542 (1981).

87. The insider trading issue is also related to the institutional-choice issue discussed below.

88. Ferris, *Profit Forecast Disclosure: The Effect on Managerial Behaviour*, 5 ACCT. & BUS. RES. 133 (1975).

89. Dev, *supra* note 85; Ferris, *supra* note 88.

rily, similar to the incentive for self-induced disclosure of historical data.⁹⁰ In addition, voluntary informal disclosure through securities analysts may be the most efficient method of communicating the information to investors.

A perfectly efficient stock market would not need the disclosure of management projections.⁹¹ The price of the security would reflect completely both management's view of the firm's future prospects and the collective judgment of investors as to the accuracy of management's opinion. But informational asymmetry exists.⁹² Realistically, management often has access to significant firm-specific information unavailable to most investors. Managers also might be better able to predict the effect of macroeconomic developments on future firm performance.⁹³ An earnings projection⁹⁴ or other soft information would reveal such data.

As a consequence of superior access to information, managers should be somewhat better able than outside investors to predict future firm value. More complete access to management's views on future worth should enhance market efficiency. Empirical evidence supports the view that managers' nonpublic data is often material. While in many instances the stock market accurately values the firm in the hands of current managers,⁹⁵ the market does not fully reflect nonpublic information. Insiders who trade outperform investors generally.⁹⁶ Moreover, announced management projections impart new information to the market, particularly if the projection is more negative than preexisting views of the firm.⁹⁷ Thus, on only an in-

90. See *supra* notes 63-65 and accompanying text.

91. Walker, *supra* note 79.

92. Gonedes, Dopuch & Penman, *Disclosure Rules, Information-Production, and Capital Market Equilibrium: The Case of Forecast Disclosure Rules*, 14 J. ACCT. RES. 89 (1976).

93. A large part of the uncertainty of all projections, including those by management, is a consequence of the effect of economy-wide events on the firm.

94. Earnings projections play a central role because in most instances the value of a firm is based on a calculation of capitalized earnings. HAWKINS & CAMPBELL, *EQUITY VALUATION: MODELS, ANALYSIS AND IMPLICATIONS* (1978).

95. See Dennis, *Valuing the Firm and the Development of Delaware Corporate Law*, 17 RUTGERS L.J. 1 (1985). This is based on the efficient market model. The market will reach an unbiased judgment of value based on all available information. If there is no unknown material fact concerning the firm, then the market price will be the best estimate of intrinsic firm worth. In many instances, under the current regulatory scheme, management's earning projection is known to the market, so that the total mix of firm-specific data is complete.

96. Finnerty, *Insiders and Market Efficiency*, 31 J. FIN. 1141 (1976); Penman, *Insider Trading and the Dissemination of Firm's Forecast Information*, 55 J. BUS. 479 (1979). The ability to outperform the market could relate to operational information concerning earnings or, in some control transaction situations, asset-valuation-based judgments.

97. Gondes, Dopuch & Penman, *supra* note 92. This also derives from Penman, *supra*

formation-content basis, management disclosure of future-oriented information provides some gain to investors.

Even though management projections do have informational value for the market as a whole, some argue that systematic mandatory disclosure could distort investment decisions and injure unsophisticated investors because of undue reliance on the projections.⁹⁸ The behavioral assumption behind this fear is that unsophisticated investors read and react to mandated disclosure documents. This assumption remains unproven.⁹⁹ Moreover, even if true, unsophisticated laypersons would not normally suffer injury because of misplaced reliance. The trading of professional investors swamps the trades of the unsophisticated.¹⁰⁰ Thus, unless sophisticated investors are also systematically misled in the same direction as unsophisticated investors, the price-signalling mechanism would protect unsophisticated investors from injury. Market professionals today have considerable, informal (but not total) access to projections without apparent market distortion,¹⁰¹ so that this type of marketwide injury is unlikely to occur.

More significant is the potential that under a system requiring the disclosure of future-oriented data, management will distort its decisionmaking so that projections are met.¹⁰² Earnings lower than projected would signal either a miscalculation of macroeconomic effects on the firm or, on a more firm-specific level, managerial failure. The stock market traditionally reacts strongly to such negative news.¹⁰³ This places managers at risk in the market for corporate control and adversely affects managerial compensation that is based

note 96. See also Nichols & Tsay, *Security Price Reactions to Long-Range Executive Earnings Forecasts*, 17 J. ACCT. RES. 140 (1979); Patell, *Corporate Forecasts of Earnings Per Share and Stock Price Behavior: Empirical Tests*, 14 J. ACCT. RES. 246 (1976); Penman, *An Empirical Investigation of the Voluntary Disclosure of Corporate Earnings Forecasts*, 18 J. ACCT. RES. 132 (1980).

98. E.g., *Union Pac. R.R. v. Chicago & N.W. Ry.*, 226 F. Supp. 400, 411 (N.D. Ill. 1964).

99. Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631 (1973).

100. Gilson & Kraakman, *supra* note 56, at 572; Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 300 (1983).

101. See *infra* notes 110-112 and accompanying text.

102. Preparation of the projection itself would not be a cost, since most firms already internally create such information. Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1200-01 (1970).

103. An analogy is the payment of dividends. Payment of dividends signals that reported earnings are real. A cut in the dividend rate is promptly reflected in a significant decline in the price of the security. See Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984).

on stock market performance. Managers are thus faced with a conflict regarding forecast disclosure, creating agency costs.

Incentives are present to understate the initial projection¹⁰⁴ and to manipulate reporting and behavior so that a projection is met. Empirical evidence shows both phenomena occurring. In Great Britain firms normally include forecasts in a prospectus to comply with the London Stock Exchange requirement that the prospectus contain a statement "as to the trading prospects of the company."¹⁰⁵ Projections are also routinely made in connection with mergers and acquisitions as a consequence of *The City Code on Takeovers and Mergers*.¹⁰⁶ A significant number of companies in Great Britain understate projected earnings when compared ex post facto with actual earnings.¹⁰⁷ Apparently, this is often intentional to avoid the negative aspects of forecast failure.¹⁰⁸ Firms also modify behavior and accounting practices to obtain operating results consistent with published disclosures.¹⁰⁹

An alleged benefit of mandated disclosure of management projections is the elimination of a "black market" in projected information. Analysts and other institutional investors regularly attempt to gain access to nonpublic management projections.¹¹⁰ Reports suggest that favored analysts obtain direct information on projections, or at least receive an indication of whether their own projections are similar to those of management. Favored analysts, or managers themselves, can then trade on the information, earning supranormal profits to the claimed disadvantage of investors without access.¹¹¹ It is hard to see how mandatory disclosure of soft information would

104. The countervailing pressure exists to inflate the projection, in order to increase the apparent value of the firm.

105. THE FEDERATION OF STOCK EXCHANGES IN GREAT BRITAIN AND IRELAND, *ADMISSION OF SECURITIES TO QUOTATIONS* (1966), quoted in Ferris, *supra* note 88. See also Comment, *British Profit Forecasting System: Model or Mistake For the United States?*, 4 CAL. W. INT'L L.J. 161, 162 (1973).

106. CITY WORKING PARTY, *THE CITY CODE ON TAKE-OVERS AND MERGERS* 3-5 (1972). Independent accountants audit these projections, just as they do with historical data. For a description of the City Code on mergers and tender offers in Great Britain, see Demott, *Current Issues in Tender Offer Regulation: Lessons from the British*, 58 N.Y.U. L. REV. 945 (1983).

107. Ninety percent of the projections issued during the time period studied by Ferris were underestimated. Ferris, *supra* note 88.

108. *Id.*

109. *Id.*

110. Managers appear to act on the incentive to trade in advance of the disclosure of the projection. Penman, *supra* note 96.

111. ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, U.S. SEC, *REPORT OF RECOMMENDATIONS*, 56 (1977).

significantly affect these practices when management may prepare a routine projection long in advance of the obligation to disclose it in an annual or quarterly report. Thus, as with mandatory disclosure generally, mandatory disclosure of projections would only have a marginal effect on insider trading.¹¹²

The policy implications of widespread legal trading on not-generally-released soft data makes the question of institutional choice particularly complex. Current regulations against insider trading only make *some* direct and tippee trading on nonpublic information illegal.¹¹³ To find illegal insider trading a court would first have to determine that the nonpublic data was material.¹¹⁴ In addition, in the tipping context, the court would have to uncover a personal pecuniary gain to the tipper arising from the tip.¹¹⁵ Pecuniary gain includes payment for the tip, information swapping, and reputational gain that may translate into future earnings for the tipper.¹¹⁶ The requirement for pecuniary gain reduces the possibility that a tip for the benefit of the tipping firm (rather than for the individual making the tip) would lead to a finding of illegal insider trading by the tippee. Although the recent insider trading scandal shows that some tips are indeed paid for with cash or by information swaps, the usual release of information to an analyst, outside the control transaction context, is for the company's benefit.

This split in the current law is sensible. The pecuniary-gain rule reduces an agency cost problem. The rule discourages selective disclosure when the motivation is individual gain, rather than benefit for the firm. Furthermore, the rule as currently constructed is consistent with the notion of self-induced disclosure. Issuers have an incentive to provide the market with soft as well as hard information, choosing the most efficient market mechanism for the dissemination of the data, although as already noted these incentives are not perfect.

Selective self-induced disclosure, as a method of disseminating

112. See *supra* note 67 and accompanying text.

113. *Dirks v. SEC*, 463 U.S. 646, 653-54, 664 (1983).

114. This would require an analysis of the same difficult factual questions the courts face when determining the importance of a management projection in the control transaction context. Moreover, information may be more important, *i.e.*, more material, to a particular expert analyst than it would be to investors generally.

115. *Dirks*, 463 U.S. at 662.

116. *Id.* at 663. Reputational gain occurs when the tipper expects some kind of personal gain in the future from the tippee, even if not a direct information swap. See *SEC v. Gaspar*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004, at 90,979 (S.D.N.Y. 1985).

management information, has considerable benefit.¹¹⁷ Analysts are efficient processors of information. They are able to verify¹¹⁸ and evaluate disclosures at a low cost; thus, disclosure through them, as opposed to a general disclosure, may reduce costs for investors¹¹⁹ and firms alike. Selective analyst disclosure may also reduce the competitive injury that might arise from disclosure of future firm activity. A collateral benefit of selective disclosure is the reduction of legal risk to the firm if the projection turns out to be in error.¹²⁰

The costs of selective tipping permitted under the pecuniary-gain rule are difficult to assess. General rather than selective release of the projection might lead to more rapid incorporation of all the information into the market price. But in many instances release of the information to enough members of the analyst community is equivalent to general release. Again, because of the sporadic nature of mandatory disclosure, an expanded mandatory duty to disclose projections should have little effect on this element of market efficiency. Selective tipping would also create the appearance that the stock market is not a fair game. The costs of this perception to the cost of capital and to the decline of personal investment in the market is again hard to quantify.

A final argument concerning the cost of mandatory disclosure of projections is the concern over liability. If a projection turns out to be incorrect, issuers fear that investors could bring a securities fraud action against the issuer and various collateral participants. Some cases do hold issuers liable for incorrect projections¹²¹ on the theory that an uninformed projection or one that was made without a reasonable basis is false.¹²² On the other hand, rule 175 protects an issuer from liability for projections included in SEC-filed documents if the issuer meets the rule's good faith, reasonable basis standard.¹²³ In addition, actions brought under rule 10b-5 require the plaintiff to prove scienter.¹²⁴ Even with the safe-harbor and scienter

117. Fischel, *supra* note 73, at 142.

118. Verification serves a monitoring function. Analysts have an incentive to protect their own reputations. They do not want, nor can they afford, to be gulled by managers; therefore, analysts should attempt to verify a selective disclosure before communicating it.

119. As with mandatory disclosure generally, this reduces wasteful search costs for the whole investor community.

120. See *supra* notes 13-19 and accompanying text.

121. *E.g.*, *Beecher v. Able*, 374 F. Supp. 341 (S.D.N.Y. 1974). See *supra* note 16.

122. *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 490 (9th Cir. 1974).

123. 17 C.F.R. § 230.175 (1986). The burden of proof is on the plaintiff to show lack of good faith and reasonable basis.

124. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 & n.12 (1976).

protections, many issuers do not formally disclose projections because of the liability concern; rather, issuers use the informal analyst network to disclose soft data. The issuers' market behavior, therefore, suggests that the liability risk is not trivial, even though there have been only a few lawsuits over projections.

Balancing the benefits and costs of the current, unregulated system of projection disclosure is an uncertain business. The unregulated projection market does not seem to have some of the costs associated with a mandatory disclosure system. Managers may be less likely with informal projections to change substantive or reporting behavior to conform firm performance with a projection. Analysts can efficiently process and verify informal communications. The concern over liability, the potential for distortion of management behavior, and the fact that self-induced disclosure through informal channels of communication might provide investors with considerable information concerning management projections all raise the issue of institutional choice. Thus, the current, unregulated market has some benefits over a mandatory system. But self-induced disclosure is not a perfect mechanism. Voluntary disclosure of soft data is particularly subject to management manipulation, as shown by the empirical data.¹²⁵ The unregulated market also creates a marginally enhanced risk of insider trading. Finally, in some instances the unregulated market does not produce sufficient access to managers' soft data—for example, when management does not disclose arguably material soft data in certain control transactions.

V. A PROPOSAL FOR LIMITED MANDATORY DISCLOSURE OF PROJECTIONS

In order to determine whether the mandatory disclosure system should be expanded to include projections, one must assess whether the gain in information from additional disclosure, as compared to market-driven, self-induced disclosure, is worth the cost of an additional mandatory disclosure requirement. The history of case development suggests that a rule-based answer is necessary. The tests proposed by the courts vary considerably, and the competing concerns can best be sorted out in a rulemaking proceeding rather than by case-by-case adjudication.

As with the debate concerning the utility of mandatory disclosure of historical data, mandatory disclosure of soft information

125. Ferris, *supra* note 88.

makes the most sense as a method for improving information processing by market professionals and when limited to situations in which incentives for self-induced disclosure are reduced. In many instances, self-induced disclosure seems to be the optimal solution. Except for the leveraged buyout situation, the incentives for managers to disclose positive soft information are high.¹²⁶ Self-induced disclosure also would presumably occur in instances in which the possibility of management distortion is low.¹²⁷ Moreover, in the routine case, senior managers of the issuer with access to the most complete information are in the best position to assess the benefits of disclosure to the firm. The cost of capital would reflect these benefits, and corporate decisionmakers would weigh the benefits against the costs to the firm of potential legal liability and competitive injury. If the competitive injury factor is high, the corporation could choose informal disclosure through analysts rather than more formal disclosure.

But in two instances the incentives for self-induced disclosure are seriously attenuated; first, when management has prepared an unexpectedly negative projection; and second, when a control transaction is pending so that managers may not believe they will be repeat players in the capital market with that firm or that the gains from the transaction might be extraordinarily large. For market professionals, access to a projection in each instance would provide significant information leading to enhanced market efficiency.

Control transactions are sufficiently sporadic and easily identifiable that it would be administratively simple to draft a rule specifically targeted at disclosure of projections and appraisals in these instances. Firms usually prepare projections for internal use in connection with transactions or other corporate activities occurring at the same time.¹²⁸ The categories of control transactions that should require mandatory disclosure of projections include issuer and consensual third-party tender offers,¹²⁹ mergers, open-market repur-

126. Ferris, *supra* note 88, shows that managers do often promptly disclose positive soft data.

127. Because of the liability risk and the possibility of adverse reaction to a missed projection, managers should voluntarily disclose projections with the highest probability of occurrence. These types of projections would be least subject to later manipulation.

128. Ruder, *Disclosure of Financial Projections-Developments, Problems, and Techniques*, 1974 INST. ON SEC. REG. 12. In acquisition analysis, informal asset appraisal is often also done. See Dennis, *supra* note 95, at 6 n.15.

129. My proposal is not intended to change the duty to speak. Some preexisting transaction or continuous disclosure obligation would trigger this expanded disclosure obligation. In addition, the purchaser in a nonconsensual, third-party tender without access to target management data should only have to disclose its own earning projections.

chase programs, and other types of going-private transactions or recapitalizations that need shareholder approval. The SEC already requires mandatory, advanced disclosure in all of these instances, except in an open-market repurchasing program.¹³⁰ Thus, it would be easy to piggy-back an additional disclosure requirement onto the preexisting regulatory scheme.

With this expanded disclosure obligation, one must ask what type of soft data needs to be disclosed and what additional supporting information a firm should disclose to ensure that the disclosure is not misleading. Since firms are primarily valued on the basis of future earnings, disclosure of earnings projections should be a core item of any expanded disclosure requirement. An additional disclosure of any appraisal could be justified if corporate decisionmakers prepared or used asset valuations in any reportable transaction. With respect to supporting data, the current regulatory scheme gives some deference to the issuer. There is no absolute obligation to disclose assumptions or information concerning the certainty of those assumptions.¹³¹ If a firm does not disclose these data and they are subsequently deemed material, the projection can be deemed materially false.¹³² A prudent issuer might therefore want routinely to make such disclosures. However, in some instances, an assumption might contain the most sensitive type of competitive information.¹³³ Thus, leaving the disclosure of assumptions and variance analysis to issuers' discretion is the optimal solution.¹³⁴

The unexpected, negative projection case in the absence of a

There should be no requirement that the purchaser reveal projected gains from the transaction, because this might require it to reveal its discovery gain. *See* Comment, *supra* note 3, at 117. For a similar rule-based approach to disclosure in tender offer situations, *see* Fordham Note, *supra* note 24, at 842-44.

130. When a tender offer is pending, the target must disclose any repurchase program under rule 13e-1, 17 C.F.R. § 240.13e-1 (1986).

131. Securities Act Release No. 6084, *supra* note 15. The SEC Advisory Committee on Tender Offers recommended that companies be required to disclose assumptions underlying a projection issued during a tender offer. ADVISORY COMMITTEE ON TENDER OFFERS, U.S. SEC, REPORT OF RECOMMENDATIONS (1983). The Commission did not adopt this recommendation.

132. *Beecher v. Able*, 374 F. Supp. 341, 348 (S.D.N.Y. 1974).

133. For example, knowledge of the predicted growth in market demand might be the product of expensive market research and underlie a projected increase in sales.

134. If disclosure of assumptions and variance information was mandated, a useful model of such requirements could be found in Auditing Standards Board, American Institute of Certified Public Accountants, Statement on Standards for Accountants' Services on Perspective Financial Information (1985). For a description of the accountant's role, *see* Danos, Holt & Imhoff, *Auditors' Current and Future Involvement in Corporate Financial Forecasts*, in SYMPOSIUM ON AUDITING RESEARCH (Schultz & Brown eds. 1982); Pallais & Guy, *Prospective Financial Statements*, 161 J. ACCT. 90 (1986).

control transaction presents the more difficult disclosure questions because the preexisting reporting obligations are different and the definition of a negative trigger is more imprecise. Unless a prior disclosure creates a duty to update a projection,¹³⁵ the only current reporting obligations are the 1934 continuous disclosure requirements.¹³⁶ If the expanded reporting requirement is only piggy-backed onto the current scheme, then the usual reporting trigger would be a 10-Q quarterly report. Quarterly reporting makes timeliness an issue, and reduced timeliness reduces the information gain that supports an expanded duty. The information gain is further limited by the already current duty to describe adverse trends in the management discussion section of continuous disclosure documents.

Making an unexpectedly negative projection an 8-K item could improve timeliness.¹³⁷ But if this solution were adopted, managers would face considerable uncertainty in determining when a tentative projection became sufficiently probable to require disclosure.¹³⁸ Furthermore, drafting a rule to allow an issuer to withhold some but not all projections requires an identification of exactly what constitutes an unexpectedly negative projection. Even a projection that shows substantial positive earnings can be unexpectedly negative for investors. Conversely, a lower-than-expected loss can be good news. Moreover, not making a projection report under an unexpected-negative-report regime creates the potential for litigation, even if the negative outcome was in fact unexpected by managers. Faced with these substantial implementation problems, the benefit of additional information in the market outside of the control transaction does not, in my judgment, outweigh the costs of a new regulatory program. Considering the regulatory costs, a perfect information market is not a reasonable goal. Thus, under the approach suggested here, mandatory disclosure of soft data should only be required in control transactions.

135. *Marx v. Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974).

136. Of course, for those courts who believe that projections can be material information, the rules against insider trading may well require disclosure during an issuer repurchasing program. Ruder, *supra* note 128.

137. Form 8-K now only requires disclosure of extraordinary events, such as changes in control, major acquisitions, or filing for bankruptcy.

138. An uncertain projection may not be material.