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COMMENTS

COMPANY DISCLOSURE OF EARNINGS PROJECTIONS: SHOULD INDIVIDUAL INVESTORS BE ALLOWED INTO THE "BALL PARK"?

I. INTRODUCTION

Company disclosure of earnings projections has caused much controversy over the years. After the passage of the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act), it was immediately debated whether projections of future earnings should be allowed in securities filings.¹ The Securities Exchange Commission (SEC) eventually decided that they should not. It maintained this policy for over thirty years² and then in a surprise move in 1973 it reversed course.³ The great clamor for company projections by institutional and individual investors finally forced the SEC to recognize that a company's release of earnings projections was a material event.⁴ As a result, the company practice of disclosing earnings estimates only to investment professionals on an informal basis was against the full disclosure mandate of the securities laws.⁵ To remedy this problem of

1. See discussion *infra* Part II.B.1.

2. See SEC DISCLOSURE GROUP, DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 96 (1969) [hereinafter WHEAT REPORT]. See also Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,211, at 82,666 (Feb. 2, 1973) [hereinafter SEC Release 5362].

3. See SEC Release 5362, *supra* note 2, at 82,667. Only four years before, the Wheat Commission, set up to comprehensively analyze corporate disclosure under the securities laws, endorsed the SEC policy of prohibiting projections from security filings. See WHEAT REPORT, *supra* note 2, at 76.

4. See SEC Release 5362, *supra* note 2, at 82,667.

5. See *id.* at 82,665-66.

“selective disclosure” and to provide investors with information they deemed important,⁶ the SEC decided to allow companies to release their estimates in any medium, provided that the information was disseminated “on an equitable basis to all investors.”⁷

After the publication of an influential congressional report, which amplified the importance of projections to investors,⁸ the SEC refined its policy toward earnings estimates.⁹ Previously, it did not encourage or discourage the disclosure of projections to the public.¹⁰ In 1978, however, it released a statement advocating that companies release such information.¹¹ In an effort to stimulate more issuers to publish their projections, the SEC passed a safe harbor rule in 1979, giving companies protection from liability for certain projections.¹² Ultimately, the 1979 safe harbor turned out to be a failure as even the SEC later admitted.¹³ It did not increase the amount of company disclosures and, often times, companies that did make disclosures could not invoke its protection due to the harbor’s narrowness.¹⁴

Court decisions significantly impacted company disclosure policies during the late 1970s and early 1980s. In 1977 one court affirmed that “selective disclosure,”¹⁵ the company

6. *See id.* at 82,667.

7. *Id.*

8. HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION, at 55 (Comm. Print 95-29, 1977) [hereinafter 1977 REPORT].

9. *See* Guides for Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5992, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,756, at 81,037 (Nov. 7, 1978) [hereinafter SEC Release 5992].

10. *See* Adoption of Amendment to Rule 14a-9 and Withdrawal of Other Proposals, Securities Act Release No. 5699, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,461, at 86,201 (Apr. 23, 1976) [hereinafter SEC Release 5699].

11. SEC Release 5992, *supra* note 9, at 81,037.

12. Safe Harbor Rule for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117, at 81,938 (July 2, 1979) (adopting Exchange Act rule 3b-6, 17 C.F.R. § 240.3b-6 (1997), and Securities Act rule 175, 17 C.F.R. § 230.175 (1997)) [hereinafter SEC Release 6084].

13. *See* Harvey L. Pitt et al., *Toward a Real Safe Harbor for Forward Looking Statements: A Reassessment of Rule 175*, 866 PLI/CORP. 671, 673 (1994) [hereinafter Pitt et al., *Toward a Real Safe Harbor*].

14. *See* Safe Harbor for Forward-Looking Statements, Exchange Act Release No. 33-7101, 57 Docket (CCH) 1999, 2007-08 (Oct. 13, 1994) [hereinafter SEC Release 33-7101].

15. Selective disclosure also has a broader meaning; the disclosure of any

practice of disseminating its earnings projections to only security analysts, was unlawful.¹⁶ However, it held that “differential disclosure,”¹⁷ the company practice of responding to analyst queries regarding the analyst’s own projections, did not violate the securities laws.¹⁸ Thus, a company could not proactively call a securities analyst to disclose its earnings projections.¹⁹ But it could comment on whether an analyst’s estimate of the company earnings prospects was in the “ball park,” provided that the company was “not trying to give their stock a little jiggle,” and did not “go overboard.”²⁰ Finally, with *Dirks v. SEC*²¹ in 1983, the Supreme Court weighed in on the controversial issue of analyst disclosure. It carved out a seemingly wide safe harbor for analyst communications, holding that disclosure of material non-public information to analysts is appropriate as long as the insiders providing such information are not motivated by “pecuniary gain or a reputational benefit that will translate into future earnings.”²²

Congress recently revisited the issue of corporate disclosure with the passage of the Private Securities Litigation Reform Act of 1995 (PSLRA).²³ Congress implemented the law primarily to curtail abusive securities litigation arising over forward-looking statements²⁴ by adopting a stronger pleading standard²⁵ and a new safe harbor.²⁶ A secondary goal of the legislation was the increased dissemination of company

material information to only select individuals. See *infra* note 144 and accompanying text.

16. See *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1238 (S.D.N.Y. 1976).

17. Differential disclosure refers not only to earnings guidance given only to analysts, but also to any other information reserved exclusively for the professional investment community. See *infra* note 150 and accompanying text.

18. See *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1231 (S.D.N.Y. 1976).

19. See *id.* at 1238.

20. *Id.* at 1231.

21. 463 U.S. 646 (1983).

22. *Id.* at 663.

23. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

24. See Statement of Managers—The “Private Securities Litigation Reform Act of 1995,” H.R. CONF. REP. NO. 104-369, 104th Cong. 1st. Sess. at 31 [hereinafter Statement of Managers].

25. See 15 U.S.C.A. § 78 u-4 (West 1997).

26. See 15 U.S.C.A. § 78 u-5 (West 1997).

earning estimates.²⁷ It was thought with the threat of frivolous litigation effectively eliminated companies would naturally choose a more open disclosure model and provide earning projections directly to the public.²⁸

So far only a small minority of companies disclose "earnings guidance" to the public.²⁹ The majority instead opt to disclose such information to only some in the professional investment community.³⁰ Some commentators believe that companies will never implement the more open disclosure model that Congress envisioned.³¹ They take the view that companies are reluctant to put earnings guidance in print not because of liability fears, but because of potential image problems if their projections prove grossly inaccurate.³² Others, however, believe that most companies will eventually disclose in press releases the type of guidance they currently reserve only for analysts.³³ These commentators think that once the ambiguities of the PSLRA are resolved by the courts and companies become confident that good faith earnings projections will not expose them to a flood of litigation, disclosure policies will change.³⁴ However, under this best case scenario, most companies will not disclose projections more widely for at least a few more years. In light of the fact that the current disclosure system gives some analysts and their clients a trading advantage in the market at the expense of individual investors, should the SEC let it continue, even if only for a short time? If not, what is the SEC's best course of action to remedy the situation?

This comment first examines the goals of the 1933 Act

27. See Statement of Managers, *supra* note 24, at 45.

28. See Gerald S. Backmun et al., *Forward Looking Statements and Cautionary Language After the 1995 Reform Act: An Empirical Study*, 1020 PLI/CORP. 153, 157 (1997).

29. See *infra* notes 209-210 and accompanying text. The most prominent of these companies are Intel and PeopleSoft. See Adam Lashinsky, *Looking Forward to More Companies Lifting the Veil*, SAN JOSE MERCURY, Nov. 3, 1997, at E1.

30. See *infra* notes 209-210 and accompanying text.

31. See Tom Pratt, *Litigation Reform Seen Having Minimal Impact on Information Sharing: 'Forward looking statement' may still be hazardous*, INVESTMENT DEALERS DIG., Jan. 15, 1996, at 6.

32. See *id.*

33. Telephone Interview with Ronald E.F. Codd, Chief Executive Officer of Momentum Business Applications Inc. and Former Chief Financial Officer of PeopleSoft Inc. (October 28, 1998).

34. See *id.*

and the 1934 Act, the basis of our securities laws.³⁵ The comment then outlines the SEC's and the courts' changing views on earnings projections as well as Congress's recent legislation in the area.³⁶ Next, the comment addresses the conflict between the policies underlying the securities laws and the differential disclosure realities of investor relations today.³⁷ The comment then analyzes the arguments supporting differential disclosure.³⁸ Finally, the comment concludes that due to current market dynamics, the SEC should pass a rule declaring the disclosure of earnings guidance a material event. With such a rule in place, companies who wish to give guidance to the market would have to disseminate their projections to the general public, not just a few select analysts.³⁹

II. BACKGROUND

A. *The Foundation of Securities Law: The 1933 Act and the 1934 Act*

Federal regulation of securities began with the 1933 Act⁴⁰ and the 1934 Act.⁴¹ The goal of both Acts can best be understood as the promotion of a more efficient⁴² securities market.⁴³ To achieve this goal, the legislation mandates company

35. See discussion *infra* Part II.A.

36. See discussion *infra* Part II.B-D.

37. See discussion *infra* Part III.

38. See discussion *infra* Part IV.

39. See discussion *infra* Part VI.

40. See 15 U.S.C. § 77a (1997).

41. See 15 U.S.C. § 78a (1997).

42. Market efficiency has two components: informational efficiency and allocational efficiency. JAMES D. COX ET AL., *SECURITIES REGULATION*, 36-38 (Aspen 2d. ed. 1997). "On close inspection, there are really two distinct aspects of market efficiency: informational efficiency and allocational efficiency. Informational efficiency describes the speed with which market prices adjust to new information. Allocational efficiency concerns the allocation of resources to their best or highest use." *Id.* at 38. "Prices in an efficient market more closely reflect underlying value than in an inefficient market, and scarce resources are therefore allocated more efficiently." *Id.* at 36. By mandating company disclosures, Congress with the 1933 and 1934 Acts sought to increase informational efficiency and thus increase allocational efficiency. See 1977 REPORT, *supra* note 8, at 562. "The [1933] Act was founded on the theory that informed investors seeking to maximize their own investment needs and objectives resulted in the most efficient allocation of capital among innumerable alternative investment opportunities." *Id.* at 563.

43. See 1977 REPORT, *supra* note 8, at 560. "The system of corporate dis-

disclosure of material⁴⁴ information and establishes liability for false and misleading statements.⁴⁵

The impetus behind both the 1933 Act and the 1934 Act was the stock market crash of 1929.⁴⁶ President Roosevelt blamed the market failure on the unethical and dishonest practices of many in the securities industry.⁴⁷ He called on Congress to adopt legislation mandating public companies to disclose information in order to restore "honest dealing in securities and thereby bring back public confidence."⁴⁸ It was thought that without a mandatory disclosure system: 1) some issuers would conceal or misrepresent information material to investment decisions; 2) underwriting and insiders' salaries would be too high; 3) public confidence in the markets would decrease; 4) state laws and private associations like the New York Stock Exchange would not generate the appropriate amount of corporate disclosure; and 5) criminal and civil actions would also not ensure the appropriate amount of corporate disclosure.⁴⁹

Those advocating disclosure as a solution to the market's ailments were no doubt influenced by the writings of Louis Brandeis.⁵⁰ Mr. Brandeis noted that the prospect of disclosure of certain information could deter unethical behavior and vigorously argued for adequate public disclosure of mate-

closure that emerged under the [1933] Act and the [1934] Act can best be understood as one aspect of an essentially two pronged approach that was designed to promote more efficient securities markets." *Id.*

44. The Supreme Court, in *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988), held that information is "material" if there is "a substantial likelihood [that its disclosure would be viewed] by a reasonable investor as having significantly altered the 'total mix' of information made available." *Id.* (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). It elaborated that "materiality 'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'" *Id.* at 238 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968)).

45. See 1977 REPORT, *supra* note 8, at 564-65.

46. See *id.* at 560-61.

47. See H. R. REP. NO. 85, at 1-2 (1933) (President Roosevelt's address to Congress). "I recommend to the Congress legislation for Federal supervision of traffic in investment securities in interstate commerce. In spite of many State statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities." *Id.*

48. *Id.*

49. See Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 9 (1983).

50. See 1977 REPORT, *supra* note 8, at 557.

rial facts "as a remedy for social and industrial diseases."⁵¹ Mr. Brandeis memorably pointed out that "[s]unlight is said to be the best of disinfectants; electric light the most efficient policemen."⁵²

B. *The SEC and Corporate Disclosure of Earnings Projections*

1. *The Early Years*

The 1933 Act and the 1934 Act mandate companies to disclose material facts—those matters as to which an average prudent investor ought reasonably be informed.⁵³ Because it was widely recognized, as early as the turn of the century, that the value of a security depends on estimates of future earnings in most cases,⁵⁴ the SEC immediately faced the question of whether or not companies should be allowed to disclose their projections in securities filings.⁵⁵ The SEC initially determined that companies should be able to disclose estimates,⁵⁶ but then quickly reversed itself.⁵⁷ It reasoned that projections should not be disclosed in SEC filings because they were mere conjecture,⁵⁸ which investors might rely on unreasonably,⁵⁹ and management might manipulate to their own advantage.⁶⁰ According to the SEC, the investor

51. LOUIS BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW BANKERS USE IT*, 93 (1914).

52. *Id.*

53. See Harry Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 *BUS. LAW.* 300, 307 (1961). See also note 44.

54. See Heller, *supra* note 53, at 304.

55. See *In re Thomas Bond, Inc.* 5 S.E.C. 60 (1939); *In re Ypres Cadillac Mines, Ltd.*, 3 S.E.C. 41, (1938); *In re American Kid Co.*, 1 S.E.C. 694 (1936).

56. See *In re Ypres Cadillac Mines, Ltd.*, 3 S.E.C. 41, (1938); *In re American Kid Co.*, 1 S.E.C. 694 (1936).

57. See *In re Thomas Bond, Inc.* 5 S.E.C. 60 (1939). In *Thomas Bond*, a company included in its prospectus estimates of future earnings after its presentation of past earnings. The court stated that the estimates "lend an appearance of predictability of future profits which is improper for a corporation which has yet to start business. Although stated as an estimate of future profits, the use of definite figures is misleading." *Id.* at 71.

58. See Heller, *supra* note 53, at 307; Roger J. Dennis, *Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective*, 46 *MD. L. REV.* 1197, 1198 (1987).

59. See Heller, *supra* note 53, at 307; Dennis, *supra* note 58, at 1198.

60. See Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 *N.Y.U. L. REV.* 1151, 1197 n.189 (1970) (quoting Philip Loomis, the SEC's General Counsel at the time). "[O]ver the years, we have encountered an

was just as capable as the corporate insider of projecting earnings based on previously disclosed objectively verifiable facts.⁶¹ One former SEC official outlined the SEC's general stance: "like the hero of 'Dragnet,' [the SEC] is interested exclusively in the 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."⁶²

By prohibiting companies from disclosing earnings projections in their filings, the SEC did not completely deny the individual investor access to earnings guidance from experts. The SEC allowed companies to disseminate earnings projections to the individual investors via other means such as press releases.⁶³ In the case of disclosure by press release, the SEC felt that because the information did not pass through the SEC—implicitly receiving its mark of approval—the investor would not put too much confidence in it.⁶⁴ Furthermore, the SEC believed that investment professionals would come up with their own estimates of future earnings and through the "filtration process" such information would

unscrupulous fringe among promoters whose predictions are pretty far out. We do not want them going [public] under [the SEC's] auspices." *Id.* Liability for projections was also an underlying concern. Because the common law classified bona fide projections as opinions not facts, actions in fraud and deceit could not be maintained. Thus, management could derive any benefits of the estimates without exposing itself to any liability. See Heller, *supra* note 53, at n.18. Another concern was "the difficulty of SEC and judicial review of information not objectively verifiable." Bruce A. Hiler, *The SEC and the Courts' Approach to Disclosure Obligations of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114, 1119 (1987).

61. See Heller, *supra* note 53, at 307. See also WHEAT REPORT, *supra* note 2, at 96.

It has been the [SEC]'s long standing policy not to permit projections and predictions in prospectuses and reports filed with the [SEC]. Such documents are designed to elicit material facts. Their factual character is widely recognized. Investors and their advisors are at liberty to make their own projections based on the disclosures resulting from the [SEC]'s requirements.

Id.

62. Heller, *supra* note 53, at 307.

63. See Hiler, *supra* note 60, at 1120; Dennis, *supra* note 58, at 1198.

64. See WHEAT REPORT, *supra* note 2, at 96. "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 [SEC] would be accorded a greater measure of validity by the unsophisticated investor than they would deserve." *Id.*

reach the individual investor.⁶⁵

2. *The SEC's Policy Statement of 1973*

The SEC did not change its long standing policy of prohibiting earnings projections in security filings until 1973.⁶⁶ At this time, the SEC finally recognized what the trading public long knew: management's assessment of company prospects was material information.⁶⁷ Plain and simple, when insiders spoke markets moved.⁶⁸ Unfortunately, companies prohibited from releasing projections in security filings most often released such information through informal discussions leading to uneven market dissemination.⁶⁹ To "bring order and fairness to the forecasting procedure and benefit both the public corporations and the investing public,"⁷⁰ the SEC proposed a voluntary full disclosure system.⁷¹ Companies did not have to release earnings estimates, but if they choose to do so they would have to make such information available "on an equitable basis to all investors."⁷² That is, they would have to report forecast information the same way as other material events such as earnings results, mergers, or acquisitions.⁷³

The SEC's voluntary full disclosure proposal was very in-

65. See WHEAT REPORT, *supra* note 2, at 52.

Indeed it was recognized from the beginning that a fully effective disclosure policy would require the reporting of complicated business facts that would have little meaning for the average investor. Such disclosures reach average investors through a process of filtration in which intermediaries (brokers, bankers, investment advisors, publishers of investment advisory literature, and occasionally lawyers) play a vital role.

Id.

66. See SEC Release 5362, *supra* note 2, at 82,666. "It has been the [SEC]'s long standing policy generally not to permit projections to be included in prospectuses and reports filed with the [SEC]." *Id.*

67. See *id.* at 82,665-66.

68. See *id.* at 82,666. "But, whatever the problems of regulating the prevailing existence of earnings forecasts from corporate management, their uneven circulation to outsiders, and their considerable effect on market values demand an active persistent and prudent program . . ." *Id.*

69. See SEC Release 5362, *supra* note 2, at 82,665. "For too long, discussions by corporations with outsiders on future economic performance have gone on behind a cloak of informal practice and procedure and this has led to uneven and unfair dissemination of forecast information." *Id.*

70. *Id.* at 82,666.

71. See *id.* at 82,665.

72. *Id.* at 82,667.

73. See *id.* at 82,665-66.

tricate. Under the proposal, the SEC differentiated between "reporting" and "issuing" companies.⁷⁴ Reporting companies, defined as companies reporting under the 1934 Act for a reasonable amount of time with a history of earnings and internal budgeting, could publish projections in their securities filings.⁷⁵ These companies would have to detail the underlying assumptions behind their projections and update such projections "on a regular basis, as well as in the event of material changes."⁷⁶ Issuing companies, those not meeting the requirements of reporting companies or those choosing not to be classified as "reporting companies," could publish their projections in any medium provided they filed their projections with the SEC on a special form.⁷⁷ Both reporting and issuing companies would be required to include in their annual reports the forecasts made during the year, the circumstances under which the forecasts were made, the variances between the forecasts and the actual results, and an explanation of the variances.⁷⁸ Both types of companies would also be shielded from liability for erroneous estimates if such estimates were "reasonably based in fact, prepared with reasonable care and carefully reviewed."⁷⁹

3. *The SEC's Policy Statement of 1976*

The elaborate voluntary disclosure system advocated in the SEC's 1973 policy statement was ultimately rejected in 1976 after unfavorable public comment.⁸⁰ Although the majority of commentators believed that company projections were of great value to investors, virtually all opposed the proposed system for fear that it would inhibit rather than encourage the dissemination of estimates.⁸¹

Even though the SEC declined to adopt the system it advocated in 1973, its policy towards earnings projections remained essentially the same. The SEC continued to permit

74. See Marshall M. Taylor, *The SEC Policy for Projections: New Problems in Disclosure*, 21 U.C.L.A. L. REV. 242, 247 (1973).

75. See SEC Release 5362, *supra* note 2, at 82,667.

76. *Id.*

77. See Taylor, *supra* note 74, at 249.

78. See *id.* at 248-49.

79. SEC Release 5362, *supra* note 2, at 82,668.

80. See SEC Release 5699, *supra* note 10, at 86,201.

81. See SEC Release 5992, *supra* note 9, at 81,036.

the inclusion of earnings estimates in filings.⁸² It remained concerned about equitable disclosure of company earnings estimates and reminded “issuers of their responsibilities under the federal securities laws in connection with the dissemination of [material] information.”⁸³ The SEC also maintained that companies should be shielded from liability for inaccurate projections only if their estimates were “reasonably based and adequately presented.”⁸⁴

The SEC, however, retreated from its policy decision on the materiality of earnings projections. In 1973, the SEC held that “the issuance of a forecast . . . to any outsider . . . [is] a material event.”⁸⁵ It now only held that “management’s assessment of a company’s future performance frequently *may* be material to investors.”⁸⁶ The SEC further pointed out that it was “neither encouraging nor discouraging the making and filing of projections because of the diversity of views on the importance and reliability of projections.”⁸⁷

4. *The 1977 Report of the Advisory Committee on Corporate Disclosure*

A few months before the SEC’s 1976 release, Congress formed The Advisory Committee on Corporate Disclosure (Committee) to comprehensively study the disclosure system under the 1933 and 1934 Acts, assess its validity, and provide recommendations for its improvement.⁸⁸ The formation of the Committee was spurred by scholarly debate, which doubted the worth of the mandatory system of corporate disclosure implemented by the 1933 and 1934 Act.⁸⁹ The Com-

82. See SEC Release 5699, *supra* note 10, at 86,201. “Since investors appear to want management’s assessment of a company’s future performance, however, and since some managements may wish to furnish their projections through SEC filings, the [SEC] is of the general view that it will not object to such disclosure.” *Id.*

83. *Id.* at 86,202.

84. *Id.*

85. SEC Release 5362, *supra* note 2, at 82,665-66 (emphasis added).

86. SEC Release 5699, *supra* note 10, at 86,202 (emphasis added).

87. *Id.* at 86,201.

88. See 1977 REPORT, *supra* note 8, at D-2-D-3. The Committee was made up of the following individuals: A.A. Sommer, Jr., William H. Beaver, Warren E. Buffett, John C. Burton, Victor H. Brown, Arthur Fleischer, Jr., Ray J. Groves, Deborah E. Kelly, Homer Kripke, Alan B. Levenson, Martin Lipton, Robert E. Malin, Roger Murray, David Norr, Elliot J. Weiss, Frank T. Weston. *Id.*

89. See *id.* at I.

mittee's report, issued in November of 1977, would later become the basis of further SEC policy action with regard to the dissemination of company earnings projections.⁹⁰

In formulating its report, the Committee polled a number of market participants including companies, analysts, portfolio managers, and individual investors.⁹¹ Among the survey findings were the following:

Management's principle criticism of the SEC's disclosure system was that the [SEC]'s requirements mandated the filing of unnecessary or meaningless information.⁹²

[A significant] number of analysts (18 out of 47) [had] access to company projections.⁹³

[M]anagement's own earnings projections of the company's performance were considered by analysts as being vital information in the first instance rather than simply confirmatory of the analysts' projection.⁹⁴

Almost half of the investors favored disclosure of an earnings projection in the company's annual report, although a large proportion of investors indicated that the necessary uncertainty [of predictions] makes such projections of dubious utility.⁹⁵

[I]ndividual investors and analysts are likely to utilize a fundamental approach in evaluating securities and to attempt to check and cross-check hypotheses and conclusions through other techniques.⁹⁶

On the basis of its study the Committee concluded that the mandatory disclosure system's benefits outweighed its costs and thus should be retained.⁹⁷ Underlying the Committee's conclusion were the ideas that sufficient reliable and timely information is essential to the efficient allocation of resources in the economy and that market forces and self interest cannot be relied on to assure such information.⁹⁸ The Committee articulated that the SEC's role in the corporate

90. See discussion *infra* Part II.B.5.

91. See 1977 REPORT, *supra* note 8, at I.

92. *Id.* at 29.

93. *Id.* at 80.

94. *Id.* at 55.

95. *Id.* at 273.

96. *Id.* at 300.

97. See 1977 REPORT, *supra* note 8, at XXXVIII.

98. See *id.* at II.

disclosure system is "to assure the public availability[,] in an efficient and reasonable manner[,] on a timely basis[,] of reliable, firm orientated information material to informed investment and corporate suffrage decision making."⁹⁹

On the topic of earnings projections, the Committee endorsed the SEC's departure from its old standing policy of prohibiting estimates in security filings.¹⁰⁰ There was some debate over whether the SEC should go further and actually require companies to release their earnings estimates. The Committee, in the end, opted for voluntary disclosure instead of mandatory disclosure because it felt that: 1) the SEC did not have an appropriate basis to formulate rules governing such a system; 2) companies might reasonably find that the costs of providing projections would outweigh the benefits; 3) companies should not be forced to expose themselves to risks of litigation and liability for inaccurate projections; 4) many companies would find it difficult, if not impossible, to prepare reasonable estimates; and 5) market demand may be strong enough to compel such disclosure without intervention.¹⁰¹ In addition to recommending a voluntary disclosure system for corporate earnings estimates, the Committee outlined the principal features such a system should have.¹⁰²

5. *The SEC's 1978 Policy Statement*

Just a year after the 1977 report, the SEC revisited the topic of company earnings projections and adopted many of the Committee's recommendations.¹⁰³ The SEC, following the Committee's suggestion, issued a statement permitting and encouraging all companies, without exception,¹⁰⁴ to publish projections in security filings and other mediums.¹⁰⁵ It also agreed with the Committee on the need for a safe harbor that would cover projections reasonably based and made in good

99. *Id.* at 305.

100. *See id.* at 349.

101. *See id.* at 354-55.

102. *See id.* at 356-65.

103. *See* SEC Release 5992, *supra* note 9, at 81,034. The SEC also issued a preliminary statement in response to the 1977 Report several months earlier. *See* Preliminary Response of the Commission, Securities Act Release No. 5906, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,505, at 80,046 (Feb. 15, 1978).

104. *See* SEC Release 5992, *supra* note 9, at 81,037.

105. *See id.* at 81,034.

faith.¹⁰⁶

The safe harbor proposed by the SEC, however, was different from the Committee's proposal in significant respects.¹⁰⁷ The SEC's safe harbor only protected reporting companies that were current with their filings.¹⁰⁸ The Committee's covered all companies regardless of the status of their filings.¹⁰⁹ The SEC's proposal put the burden of proof on the defendant to establish that the projection was reasonably based and prepared in good faith, while the Committee's version required the plaintiff to show that the projection was made without a reasonable basis and without good faith.¹¹⁰ Furthermore, the SEC rejected the Committee's recommendation to allow companies the freedom of filing the assumptions behind their projections and resuming or discontinuing projections.¹¹¹ It held that where underlying assumptions may be material to an understanding of the projection, disclosure may be necessary.¹¹² For example, it maintained that where a projection is "based to a significant degree upon the introduction of a new product or service meeting certain anticipated levels of sales and contribution to earnings, disclosure of the projection without this information might be misleading."¹¹³

6. *The SEC's 1979 Safe Harbor: 1934 Rule 3b-6, & 1933 Rule 175*

In 1979, the SEC eventually passed a safe harbor rule for projections made in good faith and with a reasonable basis.¹¹⁴ The adopted safe harbor contained elements derived from public commentaries and the earlier proposals articulated by the SEC and the Committee,¹¹⁵ according protection to both reporting and non-reporting companies.¹¹⁶ It covered forward-looking statements made in registration statements,

106. *See id.* at 81,037.

107. *See* SEC Release 6084, *supra* note 12, at 81,939-44.

108. *See id.* at 81,939.

109. *See id.*

110. *See id.*

111. *See id.* at 81,942.

112. *See id.*

113. SEC Release 5992, *supra* note 9, at 81,038.

114. *See* SEC Release 6084, *supra* note 12, at 81,938. The safe harbor provisions were codified in 17 C.F.R. 175 (1997) and 17 C.F.R. 240.3b-6 (1997).

115. *See id.* at 81,939-44.

116. *See id.* at 81,942-43.

1934 Act reports, annual reports to shareholders, and other documents filed with the SEC.¹¹⁷ Disclosures made outside of these documents also received protection if they were later included in such documents.¹¹⁸ The SEC justified granting safe harbor protection only for filed statements on the basis that 1) investors could better analyze the projections in conjunction with certified financial statements, 2) projections in filings would be better prepared due to the prospect of staff review, and 3) inclusion in filings would promote greater accessibility thereby minimizing concerns over selective disclosure.¹¹⁹

On other controversial issues the SEC ultimately held that: 1) the burden of proof would be placed on the plaintiff to establish that the company formulated its projection in bad faith or without a reasonable basis;¹²⁰ 2) reporting companies need only file their most recent 10-K report for coverage;¹²¹ and 3) safe harbor protection would not be accorded where the company did not disclose assumptions material to an understanding of the projection¹²² or where the company breached its duty to update.¹²³ The SEC articulated that companies had a duty to update

statements made in any filing . . . if the statements have either become inaccurate by virtue of subsequent events, or are later discovered to have been false and misleading from the outset, and the issuer knows or should know that persons are continuing to rely on all or any material portion of the statements.¹²⁴

The 1979 safe harbor formulated by the SEC was ultimately a failure as even the SEC would later acknowledge.¹²⁵ Despite according explicit protection for certain forward-looking statements, it did not increase the amount of com-

117. *See id.* at 81,943.

118. *See id.*

119. *See id.*

120. SEC Release 6084, *supra* note 12, at 81,939. The SEC noted that according to some commentators the SEC's proposal that the defendant be accorded the burden of proof was narrower than existing law and would afford less protection than no rule at all. *See id.* at 81,940.

121. *See id.* at 81,944.

122. *See id.* at 81,942.

123. *See id.* at 81,943.

124. *Id.* at 81,943.

125. *See Pitt et al., Toward a Real Safe Harbor, supra* note 13, at 673.

pany disclosures.¹²⁶ Many companies still did not report projections for fear, whether real or perceived, of shareholder litigation if their estimates proved inaccurate.¹²⁷ Those that did report their forecasts found no refuge in what they felt was an ill conceived safe harbor.¹²⁸ Companies complained that the safe harbor was deficient because it was too narrow, covering only those projections filed with the SEC.¹²⁹ Many companies made forward-looking statements in response to analyst questions.¹³⁰ Because of the great frequency of these remarks, such companies felt it impossible to memorialize every occasion.¹³¹ Companies also bemoaned that the provisions of the safe harbor were not applied in a manner that led to quick and inexpensive dismissal of fraudulent suits.¹³² Judges that were applying the safe harbor had to determine whether the projections were made in good faith and with a reasonable basis.¹³³ Deliberation on these sensitive factual questions often precluded early pre-discovery dismissal.¹³⁴ Companies further criticized the safe harbor for its failure to explicitly state under what instances companies had a "duty to update" their projections.¹³⁵

C. *The Courts and Company Disclosure of Earnings Estimates*

The judiciary's approach toward company disclosure of earnings projections has undergone extensive change over the years.¹³⁶ From the 1930s to the early 1970s, courts, like the SEC, believed that predictive information was inappropriate for SEC filings because it tended to mislead "by conveying a certitude which inherently [it could] not possess."¹³⁷

126. See SEC Release 33-7101, *supra* note 14, at 2007.

127. See *id.* at 2007.

128. See *id.* at 2007-08.

129. See *id.*

130. See *id.*

131. See *id.*

132. See SEC Release 33-7101, *supra* note 14, at 2008.

133. See *id.*

134. See *id.*

135. See *id.* at 2008-09.

136. See *id.* at 2005-07; Hiler, *supra* note 60, 1124-31; Janet Kerr, *A Walk Through the Circuits: The Duty to Disclose Soft Information*, 46 MD. L. REV. 1071, 1072 (1987).

137. *Union Pac. R.R. v. Chicago & N.W. Ry.*, 226 F. Supp. 400, 409 (N.D. Ill. 1964). In *Union*, the court found an analyst's report containing earnings esti-

During this period, courts also did not recognize that projections made by management outside of securities filings were "facts" that could be held as false and misleading under the securities laws.¹³⁸

In the 1970s, with the shift in SEC policy allowing the inclusion of company earnings forecasts in SEC documents, courts reconsidered their prior holdings on the topic of projections. In *Marx v. Computer Science*,¹³⁹ the court for the first time held that an earnings projection had "fact" components that could bring it under security law scrutiny.¹⁴⁰ The court noted that predictive statements are not actionable as false statements simply because they prove inaccurate.¹⁴¹ It explained that underlying every projection there are two implicit factual representations: 1) the statement was made in good faith and 2) the statement was made with a reasonable basis.¹⁴² In the event that the plaintiff can show either lacking, a valid claim arises.¹⁴³

One court in the mid 1970s recognized the propriety of differential disclosure. Like the SEC, the judiciary believed that selective disclosure¹⁴⁴—companies providing their earnings projections to analysts without releasing the estimates more widely—was against the securities law prohibition of insider trading.¹⁴⁵ The *Bausch & Lomb* court¹⁴⁶ declared,

mates for the corporation to constitute proxy materials. Because the report contained estimates it was deemed to be false and misleading. *See id.* at 410.

138. *See* SEC Release 33-7101, *supra* note 14, at 2006.

139. 507 F.2d 485 (9th Cir. 1974).

140. *See* SEC Release 33-7101, *supra* note 14, at 2006.

141. *See Marx*, 507 F.2d at 489-90.

142. *See id.* at 490.

143. *See id.*

144. The term "selective disclosure" has a second meaning. It is also used to describe the company release of any material information only to select individuals.

145. *See SEC v. Bausch & Lomb, Inc.*, 420 F.Supp. 1226, 1238 (S.D.N.Y. 1976). The prohibition against insider trading is based on Section 10b of the 1934 Act and Rule 10b-5. Section 10b provides:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. 78j (1997). Rule 10b-5, which was promulgated under Section 10b, states:

however, that a company could indicate whether an analyst's estimate was in the "ball park"¹⁴⁷ provided it did not "go over-

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, . . . [t]o employ any device, scheme, or artifice to defraud . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, or . . . [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. 240.10b-5 (1997).

Interpreting Rule 10b-5, courts have established two theories of liability for "insider trading." Under the classical theory, Rule 10b-5 is violated "when a corporate insider trades on the basis of material nonpublic information." *United States v. O'Hagan*, 117 S. Ct. 2199, 2207 (1997). The *O'Hagan* Court explained that "[t]rading on such information qualifies as a 'deceptive device' under § 10b . . . because 'a relationship of trust and confidence [exists] between the shareholders of a corporation and [the] insiders.'" *Id.* (quoting *Chiarella v. United States*, 445 U.S. 222, 228 (1980)). This relationship mandates that the insider disclose nonpublic material information before trading or abstain from trading in order to "prevent[] [the] insider from . . . taking unfair advantage of . . . uninformed . . . stockholders." *Id.* (quoting *Chiarella v. United States*, 445 U.S. 222, 228 (1980)). The classical theory applies to "officers, directors and other permanent insiders of a corporation but also to attorneys, accountants, consultants and others who temporarily become fiduciaries of a corporation." *Id.* Under the Misappropriation theory, Rule 10b-5 is violated when a person "misappropriates confidential information for securities trading purposes in breach of a duty owed to the source." *Id.* Here, liability is based "on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." *Id.*

In *Bausch & Lomb*, the SEC sought injunctive relief against an insider who released his company's internal earnings estimate for the upcoming quarter to an analyst. See *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1231-37 (S.D.N.Y. 1976). The court found that the executive's action constituted the disclosure of material, non-public corporate information. *Id.* at 1238. However, it denied the injunctive relief finding that there was no reasonable likelihood that the insider would violate the securities laws in the future. *Id.* at 1244.

146. 420 F. Supp. 1226 (S.D.N.Y. 1976).

147. The majority of companies continue to give "guidance" to analysts today. See *infra* note 209. This practice may expose companies to liability. Some courts have found that management's comments regarding their comfort level with analyst earnings estimates are equivalent to direct earnings projections. In *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, (3d Cir. 1997), the court summed up its position as follows:

To say one is "comfortable" with an analyst's projection is to say that one adopts and endorses it as reasonable. When a high-ranking corporate officer explicitly expresses agreement with an outside forecast, that is close, if not the same, to the officer's making the forecast. We see no reason why adopting an analyst's forecast by reference should insulate an officer from liability where making the same forecast would not.

board"¹⁴⁸ and was "not trying to give their stock a little jiggle."¹⁴⁹ The concept of differential disclosure¹⁵⁰ was thus born.

Id. at 1429. Accordingly, comfort statements may be actionable under Rule 10b-5 just like any other company statement. See *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1428-29 (3d Cir. 1997); *Moss v. Healthcare Compare Corp.*, 75 F.3d 276, 280-81 (7th Cir. 1996); *Acito v. Imcera Group Inc.*, 47 F.3d 47, 50-53 (2d. Cir. 1995); *In re Adobe Systems Sec. Litig.*, 787 F. Supp. 912, 915-16 (N.D. Cal. 1992). But see *Malone v. Microdyne Corp.*, 26 F.3d 471, 479-80 (4th Cir. 1994) (holding that comfort statements, because they are not guarantees of future performance, are not actionable as a matter of law); *Raab v. General Physics Corp.*, 4 F.3d 286, 290 (4th Cir. 1993) (holding that company projections, which are not expressed as guarantees, are not actionable because no reasonable investor would rely on such statements and a contrary policy would deter companies from discussing future prospects); *In re Newbridge Networks Sec. Litig.*, 962 F. Supp. 166, 173-74 (D.D.C. 1997); *Jakobe v. Rawlings Sporting Goods Co.*, 964 F. Supp. 1143, 1160 (E.D. Mo. 1996).

In general, for a plaintiff to state a valid claim based on Section 10b and Rule 10b-5 (for statutory text see *supra* note 145), he must show that the company made a (1) materially (2) false statement (or omitted to state a material fact that was necessary to make a statement not misleading), (3) with an intent to deceive (scienter), (4) which the plaintiff relied on, (5) causing the plaintiff's damages. See *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1417 (3d Cir. 1997). In the context of a claim based on an earnings projection, a plaintiff must show that the projection was issued without a reasonable basis to establish prong (2), a false statement. See *id.* at 1427. This burden, along with the scienter requirement, often proves the most troublesome for a plaintiff to meet. See Ronald O. Mueller and Gavin A. Beske, *Cold Comfort: The Risks of Expressing 'Comfort' with Analysts' Estimates*, INSIGHTS, July 1998, at 18, 21.

In dealings with analysts, companies must be careful about more than just its projections and comfort statements. Corporations may also be subject to 10b-5 liability stemming from their relations with analysts where they: (1) provide an analyst with false information, see *Cooper v. Pickett*, 137 F.3d 616, 623-24 (9th Cir. 1997), (2) entangle themselves with an analyst's report, see *Elkind v. Liggett & Meyers, Inc.*, 635 F.2d 156, 163 (2d Cir. 1980); *In re Syntax Sec. Litig.*, 855 F. Supp. 1086, 1097 (N.D. Cal. 1994), or (3) disseminate an analyst's report, see *In re Cypress Semiconductor Securities Litig.*, 891 F. Supp. 1369, 1377 (N.D. Cal. 1995).

148. Presumably, the court, in stating that a company should not go "overboard" with "ball park" estimates, was reminding corporations of the securities laws prohibition on insider trading. Where a company's "ball park" guidance would be materially different from the analyst community's or market's expectation, providing such guidance to a select few may go "overboard" and constitute the disclosure of inside information. See *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1232 n.1 (S.D.N.Y. 1976). "Mr. Wright: Would it be proper for a company officer to discuss the implications on earnings of a volume of business somewhat larger than that forecast at the time of the annual meeting. Mr Loomis: Yes, provided they don't go overboard." *Id.*

149. *Id.* at 1231. Presumably, the court, in noting that "ball park" guidance would be inappropriate if made to "give the stock a jiggle," was reminding corporations of their obligation under the securities laws to be truthful in the marketplace. Under Rule 10b-5 companies are liable for comments designed to artificially increase or decrease their stock price.

150. The term "differential disclosure" evolved from the idea that a profes-

The court thought this policy was appropriate because the analyst provided the market a needed service of "culling and sifting available data," yielding helpful analysis.¹⁵¹ The idea that such disclosure was improper because investors did not have the same access was dismissed, at least in part, because of distribution realities. The court recounted comments made by Philip Loomis, the one time General Counsel of the SEC. Mr. Loomis took the position that company disclosure to analysts is not improper for "the mere fact that [the information] has not already been disseminated," because a contradictory policy would require companies "to send their stockholders something the size of a telephone book."¹⁵²

The Supreme Court eventually tackled the issue of disclosure to analysts in 1983. In *Dirks v. SEC*,¹⁵³ an analyst, with information provided by insiders, exposed massive fraud in a publicly traded company, but not before passing news of management's transgressions to his clients.¹⁵⁴ The Court started its discussion of the analyst's potential insider trad-

sional investment advisor needed more detailed disclosure than the average investor. See William H. Beaver, *Current Trends in Corporate Disclosure*, J. OF ACCOUNTANCY, Jan. 1978, 44-51. In its broadest use, differential disclosure means *any information* given only to investment professionals. *Id.* See also STANDARDS OF PRACTICE FOR INVESTOR RELATIONS 31 (National Institute of Investor Relations 1st ed. 1998).

The concept of "differential disclosure" is based on the notion that, ordinarily, analysts and portfolio managers need more detailed information to make their analyses and assessments regarding a company's performance and prospects than individual investors or financial reporters require. "Differential disclosure" can be a form of selective disclosure that can be detrimental to the financial markets when a company goes into greater detail in its discussions with analysts and portfolio managers, yet refuses to provide the same level of information to the media upon request. Should individual investors or reporters request the sort of detailed information that has been provided to analysts or portfolio managers, the company should provide it.

Id. In recent years, differential disclosure has become a term of art for describing *earnings guidance* given only to investment professionals. See Telephone Interview with Lou Thompson, President of the National Institute for Investor Relations (January 12, 1998). Under the National Institute's view described above, the difference between appropriate and inappropriate disclosure to analysts (i.e. differential and selective disclosure) is whether the company will give out the same information to others when queried. This distinction is hollow when one realizes that those not a part of the professional investment community have virtually no opportunity to pose questions to management.

151. *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1230 (S.D.N.Y. 1976).

152. *Id.* at 1230 n.1.

153. 463 U.S. 646 (1983).

154. See *id.* at 648-50.

ing liability recognizing the important role analysts play in the market. By “ferret[ing] out and analyz[ing] information” through talks with corporate insiders, analysts are “necessary to the preservation of a healthy market.”¹⁵⁵ The Court went on to establish that the analyst defendant could only be liable for insider trading if the insiders who relayed information to him breached their fiduciary duties owed to the company.¹⁵⁶ Whether an insider breaches his duty to the company through disclosure of confidential information depends on the insider’s purpose for the disclosure.¹⁵⁷ If the insider “receives a direct or indirect benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings” the insider breaches his fiduciary duty.¹⁵⁸ If the insider discloses material non-public information, for a corporate business purpose, not personal gain, however, no breach occurs.¹⁵⁹

Importantly, the court pointed out that under this standard, an insider violates his fiduciary duty by making a gift of confidential information to a third party.¹⁶⁰ The Court explained that in such a case, the insider is deemed to have received personal benefit because “the tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.”¹⁶¹ Recognizing that whether “an insider personally benefits from a particular disclosure . . . will not always be easy for the courts,”¹⁶² the Court held that the analyst was not liable because the insiders who tipped him were not motivated by their own personal gain or the personal gain of the analyst but “by a desire to expose fraud.”¹⁶³

The *Dirks* Court, in effect, set up a safe harbor for insider disclosure to analysts.¹⁶⁴ The standard allows an in-

155. *Id.* at 658 (quoting 21 S.E.C. Docket 1401, 1406 (1981)).

156. *See id.* at 661-62.

157. *See id.* at 662.

158. *Id.* at 663.

159. *See Dirks v. SEC*, 463 U.S. 646, 667 (1983).

160. *Id.* at 664. “The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend.” *Id.* “The tippees received no monetary or personal benefit for revealing Equity Funding’s secrets, nor was their purpose to make a gift of valuable information to *Dirks*.” *Id.* at 667.

161. *Id.* at 664.

162. *Dirks v. SEC*, 463 U.S. 646, 664 (1983).

163. *Id.* at 666.

164. *See Donald C. Langevoort, Investment Analysts and the Law of Insider*

sider to disclose confidential information to an analyst as long as the insider is not motivated by personal gain, notwithstanding the fact that the information disclosed ultimately provides a trading advantage to the analyst.¹⁶⁵ The safe harbor presumably does not apply where insiders disclose information to analysts that is certain to have a considerable effect on the company's stock price (i.e. providing analysts with news of a significant revision in its earnings forecast for the upcoming quarter before issuing a press release revealing the same), because in such situations the insider is likely to receive a reputational benefit from the disclosure.¹⁶⁶ However, where an insider communicates

Trading, 76 VA. L. REV. 1023, 1033-34 (1990).

165. See *Dirks v. SEC*, 463 U.S. 646, 661-62 (1983).

In contrast to the extraordinary facts of this case, the more typical situation in which there will be a question whether disclosure violates the insider's Cady, Roberts duty is when insiders disclose information to analysts. In some situations, the insider will act consistently with his fiduciary duty to shareholders and yet release of the information may affect the market. For example, it may not be clear—either to the corporate insider or to the recipient analyst—whether the information will be viewed as material nonpublic information. Corporate officials may mistakenly think the information already has been disclosed or that it is not material enough to affect the market. Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to the insiders. And absent a breach by the insider, there is no derivative breach.

Id. (citations omitted).

166. In *Stevens v. SEC*, 48 S.E.C. Docket 739 (1991), the Chief Executive Officer of a small corporation traded on the American Stock Exchange called a number of analysts to tell them that the company would not meet its earlier earnings forecast one day before disclosing the same in a press release. See John C. Coffee Jr., *The SEC and the Securities Analyst*, N.Y.L.J. at 5 (May 30, 1991). The SEC alleged that the CEO breached his fiduciary duty to the company's shareholders because he received a reputational benefit by pre-releasing the earnings shortfall to the analyst community. *Id.* In the end, Mr. Stevens agreed to a consent decree permanently enjoining him from violating Section 17(a) of the 1933 Act, Section 10(b) of the 1934 Act, and Rule 10b-5. See *SEC v. Stevens*, 48 S.E.C. Docket 739 (1991). Mr. Stevens also agreed to pay over \$126,000, which represented the amount of losses avoided by investors who received material nonpublic information as a result of his tips to analysts. See *id.*

Professor Coffee takes the position that the SEC's reading of "personal gain" in *Stevens* is too broad. See John C. Coffee, Jr., *The SEC and the Securities Analyst*, N.Y.L.J. May 30, 1991, at 5. He elaborates that *Stevens*, as the CEO and a substantial shareholder, pre-released information to a group of analysts to maintain corporate credibility. *Id.* Professor Coffee holds that: "to the extent that any 'reputational benefit' resulted from Stevens' conduct, it accrued to [the company] and all its shareholders proportionately, and thus

information of only slight worth, such as its expectations for year-ahead earnings, the safe harbor established by *Dirks* most likely applies. Under such a scenario, because the corporate practice of giving guidance to analysts is the norm,¹⁶⁷ an insider disclosing such information would be motivated not by personal gain, but by a corporate desire to maintain good relations with analysts.¹⁶⁸ Regarding the company practice of disclosing guidance to analysts, the *Dirks* decision ultimately did nothing more than restate the *Bausch & Lomb* decision in terms of fiduciary theory.

D. *The Private Securities Litigation Reform Act of 1995*

1. *The Goals of Reform*

Congress revisited the topic of company forecasts with the PSLRA.¹⁶⁹ It passed the legislation to put an end to the excessive litigation public companies endured as a result of making forward-looking statements that proved incorrect.¹⁷⁰ Although Congress's primary goal, unlike the SEC in 1979, was not the increase of company projections disseminated to the public, it believed that by cracking down on non-meritorious fraud claims, dissemination would follow.¹⁷¹

Congress' particular concern in 1995 was the "strike suit,"¹⁷² a securities action filed not to compensate victims, but to extort a substantial settlement from a corporation and other deep pocket defendants such as auditors.¹⁷³ In a typical scenario, after a substantial drop in a company's stock price, plaintiffs' lawyers would scour public statements attributed

should not amount to a personal gain for purposes of *Dirks*." *Id.* Under Professor Coffee's approach, an insider would not be guilty of insider trading absent a more direct showing that the analyst sold information "in return for a reputational benefit that translates into future earnings." *Id.*

167. See *infra* note 209.

168. Alternatively, the court could dismiss an insider trading action against an executive for providing year-ahead guidance discreetly to analysts under the assumption that such information is not material because of its inherent uncertainty.

169. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

170. See Statement of Managers, *supra* note 24, at 31.

171. See Backmun et al., *supra* note 28, 157.

172. See Private Securities Litigation Reform Act 1995, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,629, at 86,757 (June 19, 1995) [hereinafter PSLRA].

173. See Statement of Managers, *supra* note 24, at 31.

to management looking for any comment that could be interpreted as projecting better times ahead.¹⁷⁴ The attorneys would then institute a 10b-5 class action suit,¹⁷⁵ alleging that management intentionally made a fraudulent statement concerning its future that artificially inflated the company's stock price and, therefore, caused later purchasers to overpay.¹⁷⁶ Corporations would, in the end, opt to settle the case regardless of its merits to avoid a myriad of costs: millions of dollars in discovery and litigation expenses, time drain on top management, and negative publicity.¹⁷⁷

In addition to causing corporations to expend large sums of money either in defense or settlement of a frivolous claim, strike suits had the effect of chilling disclosure of forward-looking information.¹⁷⁸ Companies, particularly those in biotech, high tech, and other high growth industries, limited the amount of forward-looking information released to the public or eliminated such disclosure in order to shield themselves from litigation.¹⁷⁹ This had the effect of adding to the cost imposed on public companies by increasing some companies' perceived riskiness thus forcing them to pay more to secure capital.¹⁸⁰ Congress also believed 10b-5 suits profited lawyers not plaintiffs.¹⁸¹ The SEC noted that investors typically recovered only 7 to 14 cents for every dollar lost as a result of fraud.¹⁸²

After extensive debate, Congress passed the PSLRA over President Clinton's veto.¹⁸³ The Act tackles the problem of frivolous litigation primarily in three different ways. First, it

174. See Statement of Managers, *supra* note 24, at 37.

175. See *supra* note 147 for elements of a 10b-5 claim.

176. See Harvey L. Pitt et al., *Promises Made, Promises Kept: Practical Implications of the Securities Litigation Reform Act*, 33 SAN DIEGO L. REV. 845, 847 (1996) [hereinafter Pitt et al., *Promises Made, Promises Kept*].

177. See Statement of Managers, *supra* note 24, 37. Some commentators believed that the average settlement rate of 93% for class actions securities fraud suits lended support to the premise that suits were decided not on the merits but on the size of the defendants' pocketbooks. See Reform Act 1995, *supra* note 172, at 86,760.

178. See Statement of Managers, *supra* note 24, at 42.

179. See PSLRA, *supra* note 172, at 86,758.

180. See *id.*

181. See *id.*

182. See *id.*

183. See Jeffrey Taylor, *House Votes to Override Veto of Securities-Suit Bill*, WALL ST. J., Dec. 21, 1995, at A3; Jeffrey Taylor, *Congress Sends Business a Christmas Gift*, WALL ST. J., Dec. 26, 1995, at A2.

attempts to put control of such suits in the hands of real clients.¹⁸⁴ Lawyers, before the passage of the PSLRA, would typically file suit for one of the many "professional plaintiffs" in their stable.¹⁸⁵ These plaintiffs would be mere figureheads having no say in the way the litigation turned out.¹⁸⁶ The PSLRA requires courts to choose as lead plaintiff the party most capable of adequately representing the class.¹⁸⁷ It creates a rebuttable presumption that the most appropriate representative will be the party with the "largest financial interest in the relief sought by the class."¹⁸⁸

Second, the legislation raises the bar for what types of cases make it to trial.¹⁸⁹ In order to survive a motion to dismiss for failure to state a claim,¹⁹⁰ the complaint must "with respect to each act or omission alleged . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."¹⁹¹ Furthermore, all discovery in the action is stayed while such a motion is pending.¹⁹² Congress tailored these provisions to reduce suits that are filed only in hopes of uncovering damaging information in discovery.¹⁹³

Third, the PSLRA grants safe harbor protection to certain company projections.¹⁹⁴ Realizing that predictive statements are the object of much securities litigation, Congress instituted a two pronged safe harbor to mitigate litigation risk and thus encourage the disclosure of forward-looking information.¹⁹⁵

The PSLRA's safe harbor addresses most of the perceived deficiencies of the SEC's 1979 safe harbor. First, it protects forward-looking statements, both oral or written,¹⁹⁶ issued by

184. See Pitt et al., *Promises Made, Promises Kept*, *supra* note 176, at 848.

185. See Statement of Managers, *supra* note 24, at 33-34.

186. See Harvey L. Pitt et al., *Promises Made, Promises Kept*, *supra* note 176, at 848.

187. 15 U.S.C.A. § 78 u-4 (West 1997).

188. 15 U.S.C.A. § 78 u-4 (West 1997).

189. See Harvey L. Pitt et al., *Promises Made, Promises Kept*, *supra* note 176, at 848-49.

190. See 15 U.S.C.A. § 78 u-4 (West 1997).

191. 15 U.S.C.A. § 78 u-4 (West 1997).

192. See 15 U.S.C.A. § 78 u-4 (West 1997).

193. See Statement of Managers, *supra* note 24, at 37.

194. 15 U.S.C.A. § 78 u-5 (West 1997).

195. See Harvey L. Pitt et al., *Promises Made, Promises Kept*, *supra* note 176, at 849

196. See 15 U.S.C.A. § 78 u-5 (West 1997).

certain parties when made outside of certain security filings.¹⁹⁷ It provides protection for a written forward-looking statement if "immaterial" or "identified as a forward-looking statement and . . . accompanied by meaningful cautionary language identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."¹⁹⁸ The safe harbor is applicable to an oral forward-looking statement if the statement is "accompanied by a cautionary statement (i) that the particular statement is a forward-looking statement and (ii) that the actual results might differ materially from those projected."¹⁹⁹ An oral projection must also be accompanied by "an oral statement that additional information concerning factors that could cause actual results to materially differ . . . is contained in a readily available written document."²⁰⁰ Finally, the safe harbor protects the defendant if the plaintiff fails to prove that the forward-looking statement was made with actual knowledge that it was false or misleading.²⁰¹

The PSLRA touches on the issuer's duty to update, another controversial issue debated in 1979. The safe harbor states that: "[n]othing in this section shall impose upon any person a duty to update a forward looking statement."²⁰² This section could be interpreted, in favor of companies, as imposing no duty to update.²⁰³ Some commentators believe, however, that since it does not explicitly strike down an issuer's duty to update, some courts might rule that a judicially created duty to update continues in vitality.²⁰⁴

The safe harbor has important limitations. Coverage under the safe harbor does not extend to those convicted of certain felonies or misdemeanors and those issuing penny stock.²⁰⁵ The safe harbor also does not protect projections made in financial statements or registration statements.²⁰⁶

197. See 15 U.S.C.A. § 78 u-5 (West 1997).

198. 15 U.S.C.A. § 78 u-5 (West 1997).

199. 15 U.S.C.A. § 78 u-5 (West 1997).

200. 15 U.S.C.A. § 78 u-5 (West 1997).

201. 15 U.S.C.A. § 78 u-5 (West 1997).

202. 15 U.S.C.A. § 78 u-5. (West 1997).

203. See Harvey L. Pitt et al., *Promises Made, Promises Kept*, *supra* note 176, at 857.

204. See *id.*

205. See 15 U.S.C.A. § 78 u-5 (West 1997).

206. See 15 U.S.C.A. § 78 u-5 (West 1997).

Furthermore, it does not cover statements in connection with a roll-up transaction, a going private transaction, a tender offer, or an initial public offering.²⁰⁷

2. *The Aftermath of Reform*

The PSLRA has had no significant effect on company disclosure of earnings estimates.²⁰⁸ The vast majority of companies continue to supply analysts with earnings guidance, yet balk at disseminating the same information in a press release.²⁰⁹ Of all the major companies in America, only a small

207. See 15 U.S.C.A. § 78 u-5 (West 1997).

208. So far the results regarding frivolous lawsuits are mixed. The number of federal court filings has decreased moderately, but the total number of securities fraud cases has remained the same. The number of filings in state court, where the PSLRA is inapplicable, have increased dramatically. See 1997 WL 14153290 (testimony of Grundfest and Perino) (Oct. 29, 1997).

209. See National Investor Relations Institute, *A Study of Corporate Disclosure Practices*, May 1998, at 7 (on file with the *Santa Clara Law Review*) (survey found 71% of companies express their level of "comfort" with analyst earnings estimates); Lashinsky, *supra* note 29; Jeffrey M. Laderman, *Wall Street's Spin Game Stock Analysts Often Have a Hidden Agenda*, BUS. WK., October 5, 1998, at 150; Pratt, *supra* note 31 ("Perceptions of companies future prospects, of course, are a major factor in stock market performance, and regulators are well aware that top analysts and their institutional clients routinely get a better picture of the future than most retail investors do."); Neil Roland, *SEC Chief Assails Firms on Financial Forecasts Report Says Method Favors Wall Street, Urges Changes*, ARIZONA REPUBLIC (January 24, 1997) <<http://newslibrary.krmediastream.com/cgi-bin/search/ph>> ("The problem of companies giving analysts more forward looking information has been around for quite some time."). See also Leslie Scism, *Firms Increasingly Make End Runs Around Analysts*, WALL. ST. J., Aug. 30, 1993, at C1 ("For years, corporations manipulated the mood of Wall Street through private conversations with securities analysts.").

Despite the [PSLRA's] encouragement that companies make what lawyers call "forward looking" statements, most still prognosticate for the public as little as possible while parceling out the best stuff to analysts who can make the most of the information. Their reticence comes from fear of being sued by shareholders if results fall grossly short of expectations. So instead, companies "give guidance" through an elaborate system of winks and nudges.

For example, a company's chief financial officer will meet with a mutual fund manager. The CFO listens, say to the investors' estimate for quarterly earnings and then will make utterances like, "Well, I can't tell you the correct figure, but I think you're being too conservative."

Lashinsky, *supra* note 29.

By and large [analyst] estimates do little more than parrot the company line. Consider that over the last 20 years the range of analyst estimates has narrowed from 8% to 4% according to I/B/E/S Inc., which collects and distributes earnings estimates to the Street. That sug-

minority take notice of the individual investor, regularly providing earnings guidance in press releases and postings on the Internet.²¹⁰ The most prominent companies in this disclosure camp are Intel and PeopleSoft.²¹¹

PeopleSoft's approach to investor relations is particularly innovative and worth discussing in detail.²¹² The company "seeks to create a level playing field of financial and business information, both historical and prospective, that is univer-

gests that analysts are doing less original work and hewing closer to the company service.

Jefferey M. Laderman, *Wall Street's Spin Game Stock Analysts Often Have a Hidden Agenda*, BUS. WK., October 5, 1998, at 150.

[Typically companies hold a] 2:00 p.m. conference call, West Coast Time, after the market closes . . . [The conference call ends at] 3:00 p.m. and then the analysts call in one by one from 3:00 p.m. until 7:00 p.m. talking to the CFO getting . . . the guidance ranges. I have some companies that literally will build your entire [profit and loss statement] for you. [Companies say] we want your revenues in this range, your margins in this range, your earnings in this range, and if you are outlying that range they get [angry].

Todd Bakar, Director of Research Hambrecht & Quist, Remarks at Gibson, Dunn & Crutcher Conference: Emerging Issues: Dealing with Analysts and the Financial Press (October 30, 1998) (transcript on file with the *Santa Clara Law Review*) [hereinafter Bakar].

210. See National Investor Relations Institute, *supra* note 209 (survey found 26% of companies routinely forecast quarterly earnings in communications (including conference calls) with investors). See also Lashinsky, *supra* note 29.

211. See Lashinsky, *supra* note 29.

212. Some of the information regarding PeopleSoft was supplied by Ronald E.F. Codd, the Chief Financial Officer of PeopleSoft until Dec. 30, 1998. At that time, Mr. Codd stepped aside to take the position of Chief Executive Officer at Momentum Business Applications Inc., a company recently spun-off by PeopleSoft. See *PeopleSoft, Inc. Appoints Ronald E.F. Codd As CEO of Momentum Business Applications, Inc. and Alfred Castino as CFO of PeopleSoft* <<http://Checkers.peoplesoft.com/Events.nsf/NewsByDate?OpenView&Expand=1.1>>. The key aspects of the company's disclosure model have not changed since Mr. Codd's departure. See *Investor Communications Policy Supplement* (visited March 27, 1999) <http://www.peoplesoft.com/en/corporate_info/investor_relations/resources_en.html> [hereinafter PeopleSoft Policy].

In one other important recent development, PeopleSoft has come under fire for its accounting practices. See Adam Lashinsky, *Hard Lesson For PeopleSoft It Falls To Earth With Other Companies*, SAN JOSE MERCURY, Jan. 29, 1999, at C1; Adam Lashinsky, *After Overcoming One Challenge To Its Accounting Practices, It Faces Another People's Party May Be Premature*, SAN JOSE MERCURY, Feb. 19, 1999, at C1. Although the SEC has investigated the company and announced that it will not have to restate earnings for prior periods, see *PeopleSoft Passes SEC Test*, SAN JOSE MERCURY, Feb. 18, 1999, at C1, a number of class action claims are still pending against the company, see *SEC Completes Review of PeopleSoft Acquisitions Resulting in No Restatement of Earnings* (Feb. 17, 1999) <<http://Checkers.peoplesoft.com/Events.nsf/NewsByDate?OpenView&Expand=1.1>>.

sally available to all in the investment community.”²¹³ As PeopleSoft’s former Chief Financial Officer, Ronald E.F. Codd, was fond of saying: “Any information that [the company] give[s] out, [it] want[s] your grandmother who lives in Oklahoma to know too.”²¹⁴ As a result, PeopleSoft, utilizing the safe harbor provided by the PSLRA, provides forward-looking information *only* in earnings releases.²¹⁵ These announcements, which are transmitted over the business wire

213. PeopleSoft Policy, *supra* note 212.

214. See Ronald E.F. Codd, Former Chief Financial Officer, PeopleSoft Inc., Remarks at Gibson, Dunn & Crutcher Conference: Emerging Issues: Dealing with Analysts and the Financial Press (October 30, 1998) (transcript on file with *Santa Clara Law Review*) [hereinafter Gibson, Dunn & Crutcher Conference].

215. See PeopleSoft Policy, *supra* note 212. In the unusual case where the company opts to supplement the forward-looking information in its earnings release, it will only do so by issuing another press release. *Id.* PeopleSoft will comment about business conditions to analysts or investors if contacted within the first two months of any quarter. *Id.* Mr. Codd explains that any information the company dispenses during this time is not going to give anyone an indication of whether the company is going to meet its forecast. See Gibson, Dunn & Crutcher Conference, *supra* note 214. Most of the company’s sales, like other Silicon Valley companies, take place toward the end of the quarter. *Id.* Information accrued within the first two months is simply inconclusive as to eventual quarterly results. *Id.* The company goes into a quiet period beginning around the first day of the third month of the quarter. See PeopleSoft Policy, *supra* note 212. (This coincides with the closure of internal stock buying. Insiders who wish to purchase PeopleSoft stock must wait until the company’s quarterly results are posted.) This means the company will only answer questions regarding historical information. *Id.* If the company wants to inform the market about any new developments during this time it will issue a press release. *Id.*

As part of their investor relations program, PeopleSoft also occasionally holds conference calls at the end of the quarter and attends analyst conferences. See Gibson, Dunn & Crutcher Conference, *supra* note 214. During these encounters, it does not disclose new information. *Id.* Once the conversation inevitably turns to earnings estimates, the PeopleSoft representative will refer back to the prior company document which contains the forward-looking projections and the appropriate safe harbor qualifying language. *Id.* PeopleSoft posts its conference calls, *Conference Call Fourth Quarter & Year Ending Dec. 31, 1998* (visited March 27, 1999) <http://www.peoplesoft.com/en/corporate_info/investor_relations/calender_en.html>, and the slides presented at conferences on its webpage, see *NationsBancMontgomery Tech Week '99* (visited March 27, 1999) <http://www.peoplesoft.com/en/corporate_info/investor_relations/calender_en.html>. Some companies tackle the investment conference differently. Intel and Microsoft, for example, provide real time audio links through their website. See *Intel 1998 Fall Analyst Meeting* (visited March 27, 1999) <http://www.intel.com/intel/finance/disclaim_fallanalyst.htm>; *Greg Maffei, CFO, Microsoft Keynote Presentation Credit Suisse First Boston Technology Conference* (visited March 27, 1999) <<http://www.microsoft.com/msft/speech/maffeicfsb.htm>>.

and reprinted on the company's website, detail the company's projections for revenues, operating margins, other income, and tax rates.²¹⁶ All that is left for interested parties is to plug in the numbers and do the math. An operations review, which is posted on the company's website on the day of the earnings release, provides in depth historical information about the company's business.²¹⁷ Most companies typically supply this level of historical information only to analysts.

The fact that most companies do not follow the disclosure paradigm embraced by Intel and PeopleSoft has not gone unnoticed.²¹⁸ Lou Thompson, President of the National Investor Relations Institute, states that the overwhelming majority of corporate executives comment on earnings projections discreetly to analysts.²¹⁹ John Lifton, a New York lawyer and

216. See *Fourth Quarter Sales and Earnings 1998* (visited March 27, 1999) <http://www.peoplesoft.com/en/corporate_info/investor_relations/pdf/PSFTQ498.pdf>. Mr. Codd relates that most corporate executives are shocked at the level of public disclosure PeopleSoft provides and believe that the company is leaving itself more vulnerable to liability than if it just reserved such information for analysts. Gibson, Dunn & Crutcher Conference *supra* note 214. Mr. Codd disagrees. *Id.* He argues that by utilizing the safe harbor in the PSLRA and sticking to a strict policy of providing only written guidance the company significantly decreases its liability risk. *Id.* First, by disclosing only written guidance, the probability that someone will allege that PeopleSoft has selectively tipped analysts about earnings surprises is slim. *Id.* Second, by providing only written guidance, the company more effectively reduces its liability risk arising from "analysts' estimates inflation creep." *Id.* The process plays out as follows. Analysts believe the company is being too conservative and thus disregard management's guidance. *Id.* When earnings results come in below aggressive analyst numbers, but in line with company expectations, the stock price drops precipitously. *Id.* If a shareholder files suit as a result, arguing fraud through the company's manipulation of analysts (for a discussion of 10b-5 liability and the entanglement theory see *supra* note 147), PeopleSoft is in a better position to defend itself than otherwise. *Id.* If it had been whispering guidance discreetly to analysts it could not bring this information up for fear that the court would disregard it completely or even use it against the company as proof of the close level of contact between the company and the analyst community. *Id.* With earnings guidance in print, the company has credible evidence that it was the analyst not the company that caused the unjustified stock price. *Id.* Incidentally, the practice of providing written earnings guidance also reduces the likelihood of "analysts' estimates inflation creep." *Id.* An analyst must feel particularly confident about his numbers before disagreeing with management, because he will have to justify such forecasts to clients who all have access to the company's views.

217. See *Operations Review Fourth Quarter 1998* (visited Mar. 27, 1999) <http://www.peoplesoft.com/en/corporate_info/investor_reltions/pdf/Q498ops.pdf>.

218. See Lashinsky, *supra* note 29.

219. See Elizabeth Mooney, *Attention to Wording is Essential to Avoid Secu-*

one time head of the American Bar Association's committee on federal regulation of securities, agrees.²²⁰ Arthur Levitt, the Chairman of the SEC, has voiced his concern with earnings guidance disclosed only to analysts. In late 1996, during a speech to 500 securities lawyers and academics, Levitt stated, "[o]ne area that is ripe for improvement is forward-looking disclosure provided by companies. Analysts typically get this information in conference calls with senior management. Other investors rarely have such an opportunity."²²¹

Why is there concern about differential disclosure in the 90s? Section 10b and Rule 10b-5 of the 1934 Act²²² forbid corporate insiders or tippees from trading in company securities on the basis of material nonpublic information if such trading breaches the insider's fiduciary duty to the company.²²³ Corporate managers know their company much better than both the individual and professional investor and thus they are in a much better position to gauge the company's earnings prospects.²²⁴ A more accurate earnings assessment is of great importance to all market players as investors in today's marketplace make investment decisions on the basis of future earnings.²²⁵ In the words of former SEC Chairman Breedon,

rities Lawsuit, RADIO COMMUNICATIONS REPORT (Dec. 15, 1997) <<http://www.rcrnews.com/archive/article.html>>.

220. See Roland, *supra* note 209.

221. U.S. Securities and Exchange Commission Chairman Arthur Levitt, Corporate Finance in the Information Age, Remarks at Securities Regulation Institute Conference (Jan. 23, 1997) (visited Dec. 29, 1998) <<http://www.sec.gov/news/speeches/spch135.txt>>. Mr. Levitt has continued to speak on the topic of corporate disclosure to analysts. Recently, however, his remarks have focused on the practice of providing analysts with information right before it is announced publicly. U.S. Securities and Exchange Commission Chairman Arthur Levitt, A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading, Remarks at "SEC Speaks" Conference (Feb. 27, 1998) (visited Dec. 29, 1998) <<http://www.sec.gov/news/speeches/spch202.txt>> ("My preference is that calls to analysts should not come before a press release, and that—even then—these discussions should not divulge new material information not contained in that press release."); U.S. Securities and Exchange Commission Chairman Arthur Levitt, The "Numbers Game," Remarks at NYU Center of Law and Business (Sept. 28, 1998) (visited Dec. 29, 1998) <<http://www.sec.gov/news/speeches/spch220.txt>> ("Seven months ago, I expressed concerns about selective disclosure. Through conference calls or embargoed press releases, analysts and institutional investors often hear about material news before it is made public. In the interval, there is a great deal of unusual trading.")

222. See *supra* note 145.

223. See *United States v. O'Hagan*, 117 S. Ct. 2199 (1997).

224. See Kripke, *supra* note 60, at 1198.

225. See Heller, *supra* note 53, at 304. See also Langevoort, *supra* note 164,

"Understanding a company's own assessment of its future potential is among the most valuable information shareholders and potential shareholders could have about a firm."²²⁶

The disclosure of earnings guidance²²⁷—information that most, if not all, would consider material—to a discrete few, who then pass on the information to clients trading in the market, thus seems to offend the insider trading laws.²²⁸

at 1029. Long-term forecasts or projections are "material to any informed investment decision." *Id.*

226. Statement of Managers, *supra* note 24, at 42-43.

227. In the author's experience as a Junior Securities Analyst at the *Value Line Investment Survey*, companies give earnings guidance for periods covering the quarter ahead to the year ahead. Companies who comment on results soon to be reported are not giving earnings guidance in the sense referred to by this article. These companies are pre-releasing actual earnings for some period of time—whether it be a month or some period up to quarter. This type of corporate practice is clearly prohibited by the insider trading laws. See *supra* note 166 and accompanying text.

228. Assuming management can most accurately forecast the company's earnings prospects, if management only releases its forecasts to a discrete few—certain analysts and by association the analysts' clients—these individuals have an obvious information advantage over the rest of the market. Although hard to quantify, this information advantage yields a trading advantage. Take the following example. Management, having previously been silent, discloses to a few analysts that it is comfortable with current analyst consensus estimates for the upcoming quarter. This disclosure seems fairly innocuous on its face, but nevertheless it does provide the tippees with a distinct advantage. Generally, the market sets the company's stock price by factoring in the company's expected earnings and the riskiness of those earnings. The higher the risk surrounding those earnings the lower the stock price. The lower the risk the higher the stock price (investors demand compensation for taking on risk and thus will only buy risky securities at a discount). At the time the company makes its earnings disclosures, the market has made an assessment of the stock's riskiness. This risk assessment, however, does not reflect news of the company's recent endorsement of consensus earnings. This endorsement arguably makes the stock less risky. Those who receive the tip from management calculate the value of the company's stock. Their valuation of the stock yields a price higher than the current market price, reflecting their assessment of lower company risk. These individuals proceed to buy the stock at the current market price. Holding other factors about the stock constant, the price of the stock will eventually inch up to the price calculated by the tippees. Why? The tippees or even the company itself will pass on news of the company's confidence, stimulating demand for the stock (i.e. more investors will realize that the riskiness of the company's prospects is lower than previously believed and thus bid up the stock price). Even if the company or its tippees do not pass on the news of the announcement to a significant number of other market participants, the stock price will creep up when the company eventually reports earnings. Under the facts of this hypothetical, assuming management reports earnings in line with their estimates and analyst consensus, the stock price will capture the discount, however slight, that the market factored into the price to compensate investors for uncertainty surrounding the earnings report.

Surely the five to seven million investors who trade individual stocks on the Internet²²⁹ are interested in the information that analysts receive and are offended by the practice of differential disclosure.²³⁰ But at the same time, the important role an analyst plays in making the market more efficient—more “fair” in terms of pricing—is undeniable.²³¹ Does the SEC really want to interfere with the delicate relationship between analysts and companies?

3. *Securities Litigation Uniform Standards Act of 1998*

In 1998, company disclosure has again been in the news. After the passage of the PSLRA in late 1995, Congress found that plaintiffs were sidestepping the Act's reforms.²³² Instead of filing securities class action suits in federal court where the provisions of the PSLRA were applicable, plaintiffs were opting for state court, where plaintiff-friendly state law applied.²³³ To close this loophole, Congress passed the Securities Litigation Uniform Standards Act of 1998 (SLUSA),²³⁴ which mandates the removal of certain securities class action suits from state to federal court.²³⁵ Proponents of the law believe that the legislation will accomplish what the PSLRA set out to do.²³⁶ First, it will reduce the amount of frivolous lawsuits endured by companies listed on the national exchanges.²³⁷ This will in turn lead more companies to release

229. See *When the bubble burst*, ECONOMIST, Jan. 30, 1999, at 25.

230. Investors who do not subscribe to professional research are totally shut out from earnings guidance. It is true that these investors can access consensus estimates on line, see <<http://www.yahoo.com>>, but these estimates are typically not updated in a timely fashion. Investors who rely on consensus estimates as well as investors who buy professional research encounter one other big problem: these investors have no way of knowing if the analyst received the company forecast. An estimate originating from the company and ratified by an analyst arguably holds more weight than an estimate formulated by an analyst on his own.

231. See *Dirks v. SEC*, 463 U.S. 646, 658 (1983).

232. See Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, 3227 (1998).

233. See *id.*

234. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998).

235. See *Clinton Signs Law Making Securities Class Actions a Federal Case*, LIAB. WK. (Nov. 9, 1998).

236. See *Clinton Statement on Uniform Standards Act*, U.S. Newswire, November 9, 1998, available in 1998 WL 13607107.

237. See *id.*

earnings projections to the general public,²³⁸ instead of providing such estimates only to the analyst community.²³⁹

Anecdotal evidence indicates that if Congress is serious about encouraging company disclosure of earnings forecasts to the public, closing the current litigation loophole by preempting state security law may not provide the answer. Some market professionals believe that the majority of companies will not start disseminating earnings projections to the public in the near future.²⁴⁰ Many managers seem to be less concerned about the possibility of lawsuits than the image problems they would have if their forecasts were substantially off the mark.²⁴¹ Others in the industry, however, are more sanguine. One high ranking corporate executive believes that after the courts iron out the particulars of the PSLRA²⁴² over the next couple of years and company boards become confident that their good faith projections will not expose them to frivolous suits, most companies will release projections directly to public.²⁴³ Under either viewpoint, the majority of large corporations is unlikely to release ball park

238. *See id.* ("If firms know that they can rely on the Reform Act's "safe harbor" for forward-looking information, they will provide the public with valuable information about their prospects, thus benefiting investors by enabling them to make wiser decisions.").

239. *See supra* note 209.

240. *See Tom Pratt, supra* note 31.

Equity capital market pros said last week that they see no signs that companies are going to start including earnings projections in prospectuses, for example. 'Our guess is that behavior is going to change very slowly,' said Scott Sippelle, head of Morgan Stanley & Co.'s equity syndicate desk. He observed that many managers seem to be concerned less about the possibility of lawsuits than about the 'image problems' they would have if overly bullish forecasts didn't pan out.

Id.

241. *Id.*

242. The major question surrounding the PSLRA is the pleading standard requirement. There is some debate as to whether Congress intended to adopt the Second Circuit standard, the most stringent circuit court test, or an even stricter standard. *See Elliott J. Weiss, The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?*, 38 ARIZ. L. REV. 675 (1996). One securities lawyer believes three things must happen before more companies start to put guidance in press releases: 1) the PSLRA's pleading standard must be clarified, 2) the number of securities class action lawsuits filed must drop, and 3) the number of securities class action lawsuits dismissed before trial must increase. Telephone Interview with Steven Bochner, attorney at Wilson, Sonsini, Goodrich & Rosati (January 10, 1999).

243. Telephone Interview with Ronald E.F. Codd, Chief Executive Officer of Momentum Business Applications, Inc. and Former Chief Financial Officer of PeopleSoft Inc. (October 28, 1998).

guidance publicly any time soon.

III. IDENTIFICATION OF THE PROBLEM

Companies may respond to analysts' questions about earnings estimates provided they do "not go overboard" and are "not trying to give their stock a little jiggle."²⁴⁴ Analysts use this company guidance not merely to check their own projections but in fact to formulate them.²⁴⁵ Individual investors are shut out completely from this very important information and thus handicapped in the trading market.²⁴⁶ Because the PSLRA has not achieved its intended goal of increased dissemination of earnings estimates to the public and the recent passage of the SLUSA may not spur most companies to release such information any time soon,²⁴⁷ should the SEC change current policy regarding company disclosure of earnings projections? If it decides the current system of differential disclosure does not comport with the 1933 and 1934 Acts and reform is in the public's best interest, what course of action should it take?

IV. ANALYSIS

A. *The SEC's Early Views on Company Earnings Projections*

The SEC's early policy of prohibiting earnings projections²⁴⁸ in securities filings must be examined in light of current circumstances. The country in the late 1930s was still reeling from the worst financial crisis of its history, the Great Depression.²⁴⁹ With the nation's faith in the market at extremely low levels,²⁵⁰ the SEC's choice to take a more protectionist approach in dealing with earnings projections cannot be faulted. The prospect of further fraud on the individual investor in the form of unrealistic earnings projections could have undermined market confidence even more, leading to a

244. SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226, 1231 (S.D.N.Y. 1976).

245. See 1977 Report, *supra* note 8, at 55; Laderman, *supra* note 209, at 150.

246. See note 230.

247. See discussion *supra* Part II.D.

248. See discussion *supra* Part II.B.1.

249. H. R. REP. NO. 85, at 1-2 (1933) (President Roosevelt's address to Congress).

250. H. R. REP. NO. 85, at 1.

less efficient market.²⁵¹ Furthermore, one of the SEC's justifications—investors are just as able to predict the future as corporate executives²⁵²—arguably might not have been too off the mark in the 1930s. At that time, the science of budgeting was not as advanced, so the disparity between the individual and the corporate executive in terms of forecasting was not as great as it is today.

By the 1970s the SEC prohibition was certainly on more dubious footing. Management of bigger companies used projections extensively and their in depth knowledge of operations certainly gave them a clearer picture of potential earnings than the average investor. In 1970, Professor Homer Kripke related:

Generalizing broadly, it is known that most sizable corporations use projections of future sales and revenues as the basis for making very important decisions Moreover, a whole science, a branch of accounting known as budget planning is based on projections; and libraries on economics and on business are full of texts on the subject 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.²⁵³

Furthermore, other SEC justifications for prohibition were questionable. The idea that company assessments of earnings prospects had only limited value (i.e. were mere conjecture) to the ordinary investor was inaccurate. Professor Schneider reflected in 1972 what everyone long knew: "[Investors] are partly sold, and particularly in the new issue area, by verbal assurances about the prospects of the company. Such projections are at least as valuable, if not more so, than the past three year's financial record."²⁵⁴ In addition, why would the SEC have faced an impossible task in policing the reasonableness of earnings projections? In the 1970s, the SEC already allowed companies to estimate mineral resources, something just as speculative.²⁵⁵ The lifting of the

251. H. R. REP. NO. 85, at 1-2.

252. See discussion *supra* Part II.B.1.

253. Kripke, *supra* note 60, at 1197.

254. Carl W. Schneider, *Nits, Grits and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254, 255 (1972).

255. See Kripke, *supra* note 60, at 1197.

prohibition of earnings projections, therefore, was probably long overdue when the SEC changed its policy in 1973.

B. *Differential Disclosure*

Although the SEC outlawed selective disclosure when it decided to allow projections in security filings in 1973,²⁵⁶ it later acquiesced to differential disclosure even though the difference between the two disclosure techniques was minimal.²⁵⁷ With selective disclosure a company calls analysts and provides them its earnings projections.²⁵⁸ Under differential disclosure, an analyst calls a company, presents its earnings estimate, and then asks the company for comment. Companies could respond by stating whether or not the analyst's estimate was in the "ball park."²⁵⁹ If a company responded that an estimate was outside of the ball park, human nature tells us that the next question posed by the analysts would be whether another number was in the ball park.²⁶⁰ Eventually, after enough too-hot or too-cold guidance, the analyst would basically be left with the company's assessment.²⁶¹

If selective disclosure²⁶² was bad for the market and the tendency for abuse with its close cousin differential disclosure²⁶³ was inevitable, why would the SEC allow the practice? First, the court approved differential disclosure had limits. Companies could not "go overboard."²⁶⁴ If the information provided by the company was too valuable, and hence the stock price moved significantly, the company "guidance" would not be called differential disclosure, but instead selective disclosure violative of insider trading.²⁶⁵

256. See discussion *supra* Part II.B.2.

257. See discussion *supra* Part II.C.

258. See discussion *supra* Part II.C.

259. See discussion *supra* Part II.C.

260. See Carl W. Schneider, *Public Disclosures, Inside Information, and Relationships with the Financial Community*, 465 *PLI/CORP.* 63, 86 (1984).

261. See *id.*

262. See *supra* note 144.

263. See *supra* note 150.

264. See discussion *supra* Part II.C.

265. See *Elkind v. Liggett & Meyers, Inc.*, 635 F.2d 156, 167 (2d Cir. 1980) ("The stockbroker was left with the impression that 'the second quarter was going to be very poor,' which he considered significant enough to prompt the sale. We therefore conclude that the . . . tip was one of material inside information.")

Second, analyst relations with companies were thought good for the market.²⁶⁶ By ferreting out nonpublic information, analysts made the market more efficient—i.e. more accurate in terms of pricing.²⁶⁷ Accordingly, some commentators believed that by shutting down the informal analyst information network market efficiency would lessen.²⁶⁸

Third, there was no viable alternative for equalizing information access among professionals and individual investors. If a company wanted to supply its shareholders, for example, with the same information it supplied analysts, it would be forced as former General Counsel of the SEC Philip Loomis stated, “to send [its] stockholders something the size of a telephone book.”²⁶⁹

Fourth, the SEC allowed differential disclosure because it reduced a company's litigation risk if their good faith projections turned out to be wrong.²⁷⁰ Because most company comments regarding earnings were made orally to analysts in one-on-one meetings²⁷¹ the chance that these statements would later come back to be used against it in a 10b-5 action was substantially less than if the same statements were made in a press release. Without such protection from litigation risk, many companies may have totally denied the market their valuable projections.²⁷² Presumably, due to their sophistication, analysts were able to tell the difference between reasonably based estimates and estimates designed to give the company's stock “a little jiggle.”²⁷³ If an analyst felt the estimates were misleading then he or she would not disseminate such estimates and fraud would be avoided.²⁷⁴

The policy reasons above, even if valid when formulated in the 1970s, are not compelling today. The idea that differential disclosure is allowable because it only permits some, but not “too much,” information to flow via the informal ana-

266. See *Dirks v. SEC*, 463 U.S. 646, 648-50 (1983).

267. See *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1230 (S.D.N.Y. 1976).

268. See *Beaver*, *supra* note 150, at 51.

269. *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1230 (S.D.N.Y. 1976).

270. See *Dennis*, *supra* note 58, at 1217.

271. See SEC Release 5362, *supra* note 2, at 82,665.

272. See *id.* at 82,666.

273. *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1231 n.1 (S.D.N.Y. 1976).

274. See *id.*

lyst network is deficient for a number of reasons. First, it offends the concept of "fair" disclosure, which led to the prohibition on selective disclosure.²⁷⁵ Fair disclosure implies equal access of information to all investors.²⁷⁶ It is a black and white concept.²⁷⁷ If you allow one group more access, then the disclosure ceases to be fair.²⁷⁸ Second, allowing only a little inside information is not an insignificant event. If analysts are privy to information, which provides them with only a slight trading advantage, their benefit would likely be only a few percentage points in investment return.²⁷⁹ Over the long run, even just a few percentage points of extra return may add up to a significant dollar amount. The clients of an analyst or even the analyst himself, if he trades on his own, should not be entitled to such a subsidy.²⁸⁰

The premise that without differential disclosure analysts would be unable to do their job and hence the market would be inefficient is also weak. Proponents of such an argument believe that by allowing a company to respond to analysts' queries on future earnings the market is better off than if companies could only disclose such information directly to the public.²⁸¹ These proponents feel the informal question and answer process is of essential importance. Assuming company executives are not tricked by analysts into disclosing more than they are willing, however, the benefits of differential disclosure are not readily discernible. How could market

275. See Beaver, *supra* note 150, at 51.

276. See *id.* at 51. The Supreme Court has rejected the "information theory"—that the antifraud provisions require equal information among all traders. See *Dirks v. SEC*, 463 U.S. 646, 657 (1983). The theory the Court embraces, the misappropriation theory, see *supra* note 145, however, is only a slightly modified version of it. Both theories, in practice, require equal information among traders in most situations. See *supra* note 166. The misappropriation theory, however, only recognizes exceptions to this general rule in unusual circumstances. See *Dirks v. SEC*, 463 U.S. 646, 663 n.22 (1983) (discussing *Walton v. Morgan Stanley*, 623 F.2d 796 (2nd Cir. 1980), which held no violation of the insider trading laws where investment bank, in the course of investigating a company as a possible acquisition candidate for a client, received confidential material nonpublic information from the target company and subsequently traded in the target's stock, after the client abandoned the acquisition).

277. See *id.*

278. See *id.*

279. See Langevoort, *supra* note 164, at 1046.

280. See Beaver, *supra* note 150, at 51; Langevoort, *supra* note 164, at 1046.

281. See Langevoort, *supra* note 164, at 1028.

efficiency be hurt if the same information regarding earnings projections was disseminated to more individuals, the general public, then to less, certain members of the analyst population?²⁸² Market efficiency should arguably increase not lessen as a result of wider dissemination.²⁸³ If anything, the current system of differential disclosure holds back market efficiency by giving some analysts a monopoly in the trade of certain information.²⁸⁴ There are currently over five to seven million Internet traders who buy and sell securities with little or no "professional" research.²⁸⁵ Surely this segment of the population would be interested in management's projections and use them to formulate their own interpretations of a correct valuation for any given security.

Some might debate whether companies would ever disclose publicly what they currently disclose only to analysts.²⁸⁶ If companies were not given the easy option of disseminating their earnings projections to the market through differential disclosure, the market would demand such information directly. Companies would then be forced to compete on information.²⁸⁷ Investors would value more highly those companies with open disclosure policies, perceiving them as less risky than those with closed-lipped policies.²⁸⁸ If companies did not want to see the performance of their stock suffer they would release to the investing public the in-depth information they currently release only to analysts.²⁸⁹

Advocates of differential disclosure articulate three specific rationales why an informal analyst disclosure system of all types of information, not just earnings guidance, is better than a direct disclosure system in terms of market effi-

282. See Beaver, *supra* note 150, at 51.

283. See *id.*

If there is limited dissemination of the item, the competition in interpreting its implications cannot take place. It is one thing to have professionals compete with one another for the interpretations of a publicly disclosed item. It is quite another for one analyst (and the analyst's clients) to have exclusive access to that item.

Id.

284. See *id.*

285. See *When the bubble burst*, *ECONOMIST*, Jan. 30, 1999, at 25.

286. See Langevoort, *supra* note 164, at 1028-1031.

287. See PSLRA, *supra* note 172, at 86,758.

288. See *id.*

289. See *id.*

ciency.²⁹⁰ First, companies can release sensitive information into the market more quickly.²⁹¹ A company, for instance, may have a new product in the pipeline that it believes will generate substantial new sales.²⁹² The company wants this information disseminated to the marketplace to receive the reward of a higher stock price, but it does not want its competitors to learn of the product.²⁹³ By disclosing the information to an analyst on the assumption that the analyst will factor it into his or her earnings projections, but refrain from passing on the specifics of the development to others, the company can release the information to the market without really releasing it.²⁹⁴ The company achieves the best of both worlds, the increase of its stock price and the avoidance of tipping off competitors.²⁹⁵ The advantage of differential disclosure here assumes that the company trusts the analyst and that the analyst will remain faithful to his or her promise of non-disclosure of the specific development. These are very big assumptions. Companies recognize that analysts have an incentive to release specifics of any new development, at least informally to bigger accounts in order to more effectively influence decisions and curry favor.²⁹⁶ Companies would be remiss in believing that if it provides good non-public information to analysts it will not reach the competitor eventually.

A second pro-differential disclosure efficiency argument involves the credibility of the company.²⁹⁷ The theory maintains that information coming directly from the company will naturally be distrusted by the public and thus unjustly dis-

290. See Langevoort, *supra* note 164, at 1028-31.

291. See *id.* at 1029.

292. See *id.*

293. See *id.*

294. See *id.*

295. See *id.*

296. See Jonathan C. Dickey, *The New 'Entanglement' Theory: Securities Analysts Are Sued in Class Action Complaints*, INSIGHTS, March 1995, at 3, 5.

[I]f the affiliated analyst is significantly more aggressive in his or her earnings forecasts than the street consensus, his or her forecast is likely to be ignored. Similarly, if the affiliated analyst attempts to publish positive forward-looking information [that] is not in any way attributable to a company source, many institutional investors will view the information with skepticism.

Id.

297. See Langevoort, *supra* note 164, at 1030.

counted.²⁹⁸ If the same information comes from the analyst it will be better received.²⁹⁹ Thus, because of differential disclosure, the stock price will more truly reflect the companies' underlying value. Assuming that an analyst is more believable than a company, why is deception surrounding the source of information necessary to achieve efficiency gains? If a company releases information to the public and the analyst then agrees with the company's assessment, the stock price should wind up in the same place.

The third justification for differential disclosure in terms of efficiency is the carrot argument.³⁰⁰ Analysts will not continue to research unless companies reward them for their diligence.³⁰¹ By allowing companies to give information to analysts, which they do not disclose to the public, companies effectively reward analysts and thus encourage more research by analysts, thereby increasing market efficiency.³⁰² The underlying premise of this theory is that analysts receive their best information about a company from the company itself. If this is true, is not the whole analyst system a waste of resources? Could not the company, by cutting out the analyst-middleman and releasing information directly to the public, cut off this analyst welfare program, saving the public the analyst tax and freeing up human capital for a more productive use? To think that analysts' get their best information about a company from the company itself, however, is simply naïve. Analysts are not important to the market because of the access to information they possess, but because of their interpretation of the information to which they have access.³⁰³ Good analysts take what a company gives them and

298. *See id.*

299. *See id.*

300. *See id.* at 1031.

301. *See id.*

302. *See id.*

303. *See* Gibson, Dunn & Crutcher Conference, *supra* note 214.

I think it is fair to take the perspective that we're doing the analysts' job for them by writing up the operation review, by giving them all this written guidance. But the fact of the matter is that's exactly where the analyst should come in and begin to add value. [The analyst] should critically take our numbers, our guidance, our information and cross correlate it with other sources of information, [] trends in the industry, information they have on competitors and either validate it by, in effect, confirming the guidance or [disagree with it,] by taking a different position. [W]e certainly encourage our analysts to do that. We've had a few [analysts] that have, initially when we started this practice, react

puts it to the test.³⁰⁴ They talk to suppliers, customers, and competitors.³⁰⁵ Most of their best information comes from these sources not the company.³⁰⁶ Analysts in the end are important to the market because they assess management's assessment of future prospects.³⁰⁷ When they recognize an unjustified stock valuation in the market, their hard work is rewarded without company involvement.

The difficulty of distributing information is another argument that fails to justify the current policy of differential disclosure. Former SEC General Counsel Loomis' comment, that a company would have to send its shareholders a telephone book in order to maintain an equitable disclosure policy,³⁰⁸ is more hyperbole than reality. What is most important to the investor is not every piece of information a company gives to an analyst. The investor, like the professional analyst, is most interested in the conclusions management draws from every little piece of information. Those conclusions, in the form of projections, coupled with certain key underlying assumptions, would likely only take a few pages of a press release, which is certainly not cost prohibitive. Furthermore, even if Mr. Loomis is right, that an equitable disclosure policy would require the shipment of a telephone book to each shareholder,³⁰⁹ it would likely be less costly with today's technology to send that telephone book than to continue the differential disclosure system. Through the differential disclosure system companies not only have to come up with the telephone book, but also present it on numerous occasions to different analysts.³¹⁰ Such presentations

as "you're doing my job for me" and I said no I'm not, I'm not even beginning to do your job if you do it right.

Id. See also Scism, *supra* note 209. "Of course, few analysts rely solely on cryptic conversations with executives to pin down future earnings. The best combine these conversations with material gleaned from other sources, like customers, suppliers, distributors, and anyone else in the know." *Id.*

304. See Gibson, Dunn & Crutcher Conference *supra* note 214.

305. See *id.*

306. See *id.*

307. See *id.* As a result, analyst opinions will always be important to a significant number of people no matter if companies continue to disclose information under the informal system or instead release information under an open disclosure model.

308. See *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1231 n.1 (S.D.N.Y. 1976).

309. See *id.*

310. See Bakar, *supra* note 209.

take up valuable company resources in terms of labor. With Internet disclosure, the time to write the telephone book is the same, but by posting the information on the Internet only one presentation is required. Companies could then reallocate their resources for more efficient uses.

Additionally, the legal benefits derived from differential disclosure are not enough to justify the retention of the disclosure practice. Through differential disclosure, the argument goes, companies who release good faith earnings guidance to analysts are more unlikely to get hauled into court to defend 10b-5 fraud claims, because only analysts know of the projections.³¹¹ Honest companies thus save money.³¹² It is true that differential disclosure provides less opportunity for a company to get sued. But it allows both honest companies and dishonest companies to avoid litigation. Is this a proper solution? A better solution is the creation of judicial safeguards to prevent non-meritorious claims from going forward. Congress has done just that with the passage of the PSLRA. The PSLRA raises the pleading requirement so federal courts are more apt to dispose of non-meritorious cases before trial.³¹³ During the pendency of a motion to dismiss for failure to meet the pleading standard, discovery is stayed, so companies do not incur significant expenses defending such actions.³¹⁴ The passage of the SLUSA provides additional protection to honest companies by effectively preempting plaintiff-friendly state security law.³¹⁵

If the PSLRA and the SLUSA diminish honest companies' litigation risk, should not differential disclosure of earnings estimates accordingly disappear? Honest companies would not incur expenses as a result of an open disclosure policy. Companies would then adopt a more open disclosure policy, issuing projections to the general public on the assumption that it would lower its perceived riskiness and

311. See Dennis, *supra* note 58, at 1217-18.

312. The second part of this argument states that without the decreased risk of litigation that differential disclosure provides, companies would refrain from providing analysts with guidance altogether. With less information in the marketplace, market efficiency would accordingly suffer. See Langevoort, *supra* note 164, at 1029-30.

313. See discussion *supra* Part II.D.1.

314. See discussion *supra* Part II.D.1.

315. See discussion *supra* Part II.D.3.

increase its stock price.³¹⁶ Unfortunately, this scenario has not played out and may not play out in the near future. Anecdotal evidence suggests that companies do not adopt more open disclosure policies not because of litigation risk, but because of image problems if their projections prove inaccurate.³¹⁷ Under a less cynical viewpoint, most major companies will release their projections, but it will take some time.³¹⁸ Corporate board members will only change their companies' disclosure policies once they are confident that good faith projections will not expose their companies to legal liability.³¹⁹ This will only come after the courts clear up ambiguities in the PSLRA, something that might take a few more years.³²⁰

V. PROPOSAL

Company projections are acknowledged as one of the most important types of information any investor could have about a particular company.³²¹ Most companies, however, supply such assessments only to certain market professionals, leaving individual investors who do not utilize professional research uninformed.³²² Companies may eventually adopt open disclosure policies, but this is not guaranteed.³²³ In the best case scenario, most companies will not release in depth earnings estimates publicly for at least a few years.³²⁴ The SEC, whose mandate it is to ensure that investors receive "information material to informed investment and corporate suffrage decision making,"³²⁵ cannot sit idly by, letting some analysts and their clients gain at the expense of individual investors, in the hope that company disclosure will eventually become fair. The SEC should intercede on behalf of the public's interest and require fair disclosure, especially in light of the PSLRA's goal of increasing dissemination of

316. See PSLRA, *supra* note 172, at 86,758.

317. See discussion *supra* Part II.D.3.

318. See discussion *supra* Part II.D.3.

319. See discussion *supra* Part II.D.3.

320. See discussion *supra* Part II.D.3.

321. See *supra* note 226.

322. See *supra* notes 209-210.

323. See discussion *supra* Part II.D.3.

324. See discussion *supra* Part II.D.3.

325. See *supra* note 99.

earnings estimates to the public.³²⁶

This comment proposes that the SEC can bring about fair disclosure most easily by adopting a rule, modeled after its 1973 release,³²⁷ declaring that company disclosure of earnings guidance is a material event. Earnings guidance, if released at all, would then have to be made available "on an equitable basis to all investors."³²⁸

Such a policy will not work undue hardship on companies. Those who do not wish to release projections and, therefore, not reap the rewards of open disclosure policy (less uncertainty regarding the company's stock and a higher stock price)³²⁹ would not be required to do so. Those who do wish to release earnings projections to the market need only disseminate such estimates through a press release or a posting on their web page.³³⁰ Under this approach, both professional and individual investors will be informed. Nothing else in the current corporate disclosure machine needs to be altered. Analysts can continue to question management in investment conferences, one-on-one discussions, and conference calls as vigorously as ever. Corporations would only have the obligation not to reveal to a select few earnings guidance or other information that would allow a reasonable person to ascer-

326. See discussion *supra* Part II.D.1.

327. See *supra* Part II.B.2.

328. See *supra* Part II.B.2. Violations of this rule would admittedly be difficult to prove in most cases. The rule, however, would not be important because it could hold insiders accountable for unfair dissemination, but because it would put insiders on notice that it is not proper to release earnings guidance to only the professional investment community. All the major stock exchanges currently encourage listed corporations "to seek out formal and informal contact with analysts to facilitate the accurate pricing of their securities." SEC Release 33-7101, *supra* note 14, at 2009 (citing New York Stock Exchange Manual, § 202.02; American Stock Exchange Guide § 402 and National Association of Securities Dealers Investor Relations Guide, *Cultivating the Investing Community*, at 18). It is thus easy to see how today's Chief Financial Officer might believe there is nothing wrong with unequal dissemination in regards to earnings guidance. Once company officers in charge of investor relations receive a clear message on the topic of earnings guidance there is no reason to believe that the majority would not comply.

329. See PSLRA, *supra* note 172, at 86,758.

330. Although a strong case can be made for regulating differential disclosure, defined broadly as any disclosure given to only analysts, a more prudent approach is to focus initially on differential disclosure in its narrowest sense; earnings guidance given only to analysts. Companies would likely not find regulation on the latter nearly as difficult as regulation on the former. Regulation of differential disclosure in its broadest sense could always be initiated after success with intervention in the area of earnings projections.

tain the company's internal earnings estimate. Intel, arguably one of the most successful technology companies of all time, and PeopleSoft, a fast growing high tech company, are proof that such a disclosure model can be implemented with great success.³³¹

VI. CONCLUSION

Management's assessment of its future earnings prospects is of great worth to professional and individual investors alike. Yet under the present disclosure system only the professional investment community is privy to such information. Although corporations may eventually adopt a more open disclosure method after the provisions of PSLRA and the SLUSA are firmly established, this is not guaranteed. As a result, the SEC should intervene and adopt a bright line rule declaring the disclosure of earnings guidance a material event. Through such a rule, individual investors will enjoy what professional investors have enjoyed for a long time, access to the ball park.

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331. See discussion *supra* Part II.D.2. A more open disclosure model may even decrease a firm's liability risk in some cases. See *supra* note 216.
