

SEC REPORTING REQUIREMENTS FOR PUBLICLY TRADED COMPANIES SHOULD NOT BE EXPANDED DESPITE ADVANCEMENTS IN INFORMATION TECHNOLOGY

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ABSTRACT

Advancements in information technology allow information to be collected and analyzed quickly within a corporation. As a result, technology also allows the quicker release of information to the Securities Exchange Commission (SEC)—much quicker than the Form 10-K and Form 10-Q releases that are currently required for publicly traded companies. Although publicly traded companies must also disclose certain significant events in Form 8-K, the reporting requirements for publicly traded companies are not nearly as expansive as they could be considering the easy access these companies have to their business information. Even with this in mind, the SEC is well into a reevaluation of Regulation S-K primarily because requirements have accreted over time to become not just burdensome to companies but also blinding to investors who are overwhelmed by the volume of disclosure thrown at them. This paper expounds on these arguments and posits additional arguments for why the SEC should not expand reporting requirements for publicly traded companies. Specifically, expanded requirements are associated with high compliance costs; market forces already induce higher-quality disclosures; the more information companies file with the SEC, the more advantages they give to their competitors; and both the liability concerns and the doctrinal issues already associated with the current requirements will be exacerbated with an expansion of the requirements.

INTRODUCTION

Both the Securities Act of 1933 and the Securities Exchange Act of 1934 created a mandatory disclosure system in the United States. Since the passage of these laws, the reporting requirements for publicly traded companies have continued to expand, especially in regards to Form 8-K. Advancements in information technology have allowed for the creation of

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the Electronic Data Gathering, Analysis, and Retrieval System (EDGAR), Interactive Data Electronic Applications (IDEA), and extensible Business Reporting Language (XBRL)—all of which have made it easier for investors to gain access to information on publicly traded companies. Even though these technological advances have furthered one of the main goals of the securities laws—to increase investors’ access to information about publicly traded companies—further technological advances should not lead to more expansive reporting requirements.

This paper sets forth five arguments against the expansion of reporting requirements that outweigh the benefit of increasing the amount of information available to investors: expanded requirements are associated with high compliance costs; market forces—primarily an issuer’s concern for both its reputation and the scrutiny placed on it by investment analysts and the financial press—already cause higher-quality disclosures; the more proprietary information a company shares with its competitors, the more its competitive advantage decreases; and both the liability concerns and the doctrinal issues already associated with the current reporting requirements will only be exacerbated with an increase in requirements. More specifically, this article will address the following doctrinal issues: the ambiguity of ripeness and, relatedly, how best to articulate a duty to update, a duty to correct, and managers’ duties under the Management Discussion and Analysis (MD&A) requirement.

I. THE CREATION OF THE SEC DISCLOSURE SYSTEM

The Great Depression and the Stock Market Crash of 1929 provided the political momentum for congressional enactment of a mandatory disclosure system through the Securities Act of 1933 and the Securities Exchange Act of 1934.¹ Congress hoped these new laws would eliminate fraud from the market and provide assurance to investors that they would receive the returns they expected, which would keep investors from withdrawing their capital and the economy from stagnating.²

The Securities Act “regulates the public offering and sale of securities in interstate commerce.”³ At the time of its passage, it required disclosure to the Federal Trade Commission, in the form of a registration statement, when a corporation made a public offering.⁴ Since the passage of

¹ See JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 5 (7th ed. 2013).

² See Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 670 (1984).

³ COX ET AL., *supra* note 1, at 5.

⁴ See MELVIN ARON EISENBERG & JAMES D. COX, *BUSINESS ORGANIZATIONS: CASES AND MATERIALS* 355 (unabr. 11th ed. 2014).

the Securities Exchange Act, corporations are required to file registration statements with the SEC. The registration statement “seeks to assure full and fair disclosure in connection with the public distribution of securities.”⁵ Most of the substantive information required in a registration statement must also be included in the prospectus, which must be given to investors so they can “fully assess the merits of their purchase of the security.”⁶

The Securities Exchange Act of 1934 was enacted with three goals in mind: “to control the trading practices of brokers, dealers, investors, and the exchanges themselves to prevent manipulation and undue speculation”; to regulate “the behavior of issuers and managers whose stock was traded on the exchanges”; and to require “mandatory disclosure requirements for certain publicly traded issuers.”⁷ To implement the regulations authorized by the act, as well as to enforce compliance, the Securities Exchange Act created the SEC, which is now the sole administrative body in charge of enforcing securities laws. A central component of the Securities Exchange Act is the imposition of periodic-reporting requirements on corporations that: have a security listed on a national exchange (section 12(a)); have a class of equity securities held of record by 2000 persons or more or at least 500 holders who are non-accredited investors and have total assets exceeding \$10 million (section 12(g)); or have registered securities pursuant to a public offering of their securities (section 15(d)).⁸ Under section 13 of the Securities Exchange Act, these corporations must file Form 10-K annually, Form 10-Q quarterly, and Form 8-K after the occurrence of certain significant events.⁹

II. THE IMPACT OF TECHNOLOGY ON THE REPORTING REQUIREMENTS FOR PUBLICLY TRADED COMPANIES

Filings with the SEC are submitted electronically through EDGAR,¹⁰ which was introduced by Congressional mandate in 1983.¹¹ At first, registrants submitted their Securities Act registration statements and Exchange Act periodic reports through EDGAR by the physical delivery of diskettes or magnetic tapes or direct transmission over telephone lines using modems.¹² Now, all registrants must file mandated information

⁵ COX ET AL., *supra* note 1, at 5.

⁶ *Id.* at 6.

⁷ *Id.* at 580.

⁸ *See* EISENBERG & COX, *supra* note 4, at 354.

⁹ *See id.*

¹⁰ *See* COX ET AL., *supra* note 1, at 140.

¹¹ *See* SEC. & EXCH. COMM’N, REPORT ON REVIEW OF DISCLOSURE REQUIREMENTS IN REGULATION S-K, FED. SEC. L. REP. (CCH), at 6 n.31 (Dec. 1, 2013), 2013 WL 7117005.

¹² *See id.*

electronically, which most often occurs by e-mail transmission.¹³ Filed information is usually available within thirty minutes of it being filed with the SEC.¹⁴ Regulation S-T sets forth the “manner and protocol for making electronic filings,” which have the same content as paper-based filings, but require different formatting.¹⁵ Confidential passwords assigned to each registrant ensure that filed information is protected against tampering.¹⁶ In order to better facilitate “investor decision making, since 2009 the SEC has required filings to be pursuant to its [IDEA], which itself builds on a software program, XBRL . . . , by which information is ‘tagged’ by reporting companies so that users can thereafter sort information according to the pretagged code.”¹⁷ The XBRL system allows investors to quickly compare reporting items across companies.¹⁸ These advancements in information and communications technologies have become “critical to healthy and efficient primary and secondary markets” because they help further the primary goals of the federal securities laws: protecting investors and promoting fair and orderly markets.¹⁹

The Exchange Act requires periodic disclosures for certain publicly traded issuers. These disclosures were meant to make information available to investors trading in securities that is similar in quantity and quality to the information made available for public offerings of securities under the Securities Act.²⁰

A reporting company must file Form 10-K at the end of each fiscal year. Pursuant to Regulation S-K, Form 10-K must include audited financial statements; a management report; and disclosures concerning legal proceedings, conflict-of-interest transactions, and other specified issues.²¹

A reporting company must also file Form 10-Q at the end of each fiscal quarter. Pursuant to Regulation S-K and Regulation S-X, Form 10-Q must include quarterly financial data, a management report, disclosures concerning defaults on senior securities, and other specified issues.²²

¹³ See COX ET AL., *supra* note 1, at 140.

¹⁴ See *id.*

¹⁵ *Id.*

¹⁶ See *id.*

¹⁷ *Id.* at 10.

¹⁸ See *id.*

¹⁹ U.S. Sec. & Exch. Comm’n, *Report to the Congress: The Impact of Recent Technological Advances on the Securities Markets* (Nov. 26, 1997), <http://www.sec.gov/news/studies/techrp97.htm>.

²⁰ See COX ET AL., *supra* note 1, at 580.

²¹ EISENBERG & COX, *supra* note 4, at 354.

²² *Id.*

Reporting companies must file Form 8-K on the occurrence of certain significant events. The evolution of this form demonstrates how the evolution of technology has impacted the SEC disclosure system. Originally, Form 8-K had to be filed “within ten days of the end of any month during which certain significant events occurred.”²³ These significant events included certain events in a company’s operation, such as a change of control, the acquisition or disposition of a significant amount of assets, and amendments to the articles or bylaws.²⁴ In the late 1980s, the deadline for filing Form 8-K was shortened to somewhere between five to fifteen days (depending on the significant event) after the occurrence of the event.²⁵ In 2004, when computer technology could finally support its enactment and the financial and accounting scandals of 2001 and 2002 required it,²⁶ the SEC issued a rule increasing the number of reportable events to twenty-two.²⁷ The 2004 rule also shortened the disclosure deadline for filing Form 8-K to two to four business days after the occurrence of the event.²⁸

In addition to Form 8-K, the SEC also requires companies to disclose public offerings of securities by the filing of a registration statement.²⁹

In the early 1980s, the SEC adopted an integrated disclosure system, which allows certain companies registering securities under the Securities Act to “fulfill many of the [Securities] Act’s disclosure demands by incorporating into the Securities Act registration statement information from their Exchange Act filings.”³⁰ The integrated disclosure system saves corporations a substantial amount of both time and money during registration.

III. ADVANCEMENTS IN INFORMATION TECHNOLOGY SHOULD NOT CAUSE THE FURTHER EXPANSION OF REPORTING REQUIREMENTS FOR PUBLICLY TRADED COMPANIES

During the last two decades there have been dramatic improvements in information technology. The SEC’s embrace of XBRL and the evolution of Form 8-K reflect these changes. While the reason for

²³ Alina Lerman & Joshua Livnat, *The New Form 8-K Disclosures 3* (Dec. 19, 2008) (unpublished paper), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1126816.

²⁴ See COX ET AL., *supra* note 1, at 10, 581; EISENBERG & COX, *supra* note 4, at 354.

²⁵ See Lerman & Livnat, *supra* note 23, at 1.

²⁶ See COX ET AL., *supra* note 1, at 581.

²⁷ See Lerman & Livnat, *supra* note 23, at 4.

²⁸ See EISENBERG & COX, *supra* note 4, at 354.

²⁹ See *id.* at 876–78.

³⁰ COX ET AL., *supra* note 1, at 10.

requiring reporting in ninety-day increments was understandable in a paper-based reporting system, that justification is no longer reasonable given the improved ease and speed with which large amounts of data can be collected, analyzed, and presented. But technological capability should not be the sole consideration. In fact, reporting requirements should not be expanded any further due to high compliance costs, impactful market forces, unnecessary loss of competitive advantage, and the exacerbation of liability concerns and doctrinal issues.

A. Compliance Costs

The expansion of reporting requirements will increase compliance costs for reporting companies. Form 8-K provides an excellent example of this. In 2004, the number of events triggering a Form 8-K disclosure increased significantly.³¹ At the time, the SEC calculated that the 2004 amendments would increase the number of reports on Form 8-K per company per year by five, on average.³² They also calculated that each company would spend five hours filling out each form, 75% of the time spent by the company and 25% of the time spent by outside counsel, which charged, on average, \$300 per hour.³³ Based on the fact that approximately 11,800 companies filed Form 8-K reports in 2003, the SEC predicted that the total costs of hiring outside professionals for all companies combined would increase by \$22,125,000.³⁴

EDGAR, which enables companies to file reports directly with the SEC “over the Internet, without the added costs of using third parties to submit filings,” has admittedly enabled lower filing costs.³⁵ Still, EDGAR and other technological advances have not decreased filing costs enough to even come close to eliminating the high compliance costs associated with additional reporting requirements.

The SEC’s current reporting requirements may already produce too much information.³⁶ The fact that “not all, or even most, investors need to be well informed for the market to be efficient” supports this assertion.³⁷

³¹ See Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release No. 8400, Exchange Act Release No. 49424, 2004 WL 536851, at *32 (Mar. 16, 2004) [hereinafter SEC Release No. 8400].

³² See *id.* at 31.

³³ See *id.*

³⁴ See *id.*

³⁵ *Id.* at 33.

³⁶ See John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 730 (1984).

³⁷ *Id.* at 730–31.

Furthermore, a rather small portion of reporting companies—only 10% in 1977—are regularly followed by securities analysts.³⁸

The expansion of the scale and scope of securities regulation has also created fears that the reporting requirements have become overly burdensome for smaller firms.³⁹ As of 2011, the average initial compliance cost associated with conducting an initial public offering was \$2.5 million, followed by an ongoing compliance cost for issuers, once public, of \$1.5 million per year.⁴⁰ The JOBS Act and the Dodd-Frank Act have helped this problem by providing some special accommodations for smaller firms, but the costs are still onerous.⁴¹ This is cause for concern because strict regulation quite possibly has caused, and will continue to cause, atrophy of the public markets—currently, “IPOs are down severely, particularly among smaller firms, and” deregistering—which a corporation can do if it decreases its record holders to less than 300—is common.⁴² There were 52% fewer listed companies in 2013 than in 1998 and the number of listings on the New York Stock Exchange in 2011 was the lowest in over thirty-five years.⁴³

Expanded reporting requirements also mean higher compliance costs for the SEC. The SEC spends approximately \$1 billion a year enforcing securities laws⁴⁴—this figure will have to increase if the SEC is forced to spend more time on ensuring and enforcing compliance.

B. Market Forces

Some may argue that, with the exception of over burdensome requirements, increased reporting requirements will increase the amount of information available to investors, which can only be a good thing for both investors and the market. However, this argument fails to consider the influence of market forces. There “are a variety of market forces that presumptively lead to high-quality issuer disclosure.”⁴⁵ The reputational benefit to an issuer of accurate and increased disclosures and the policing

³⁸ See *id.* at 724.

³⁹ See Jeff Schwartz, *The Law and Economics of Scaled Equity Market Regulation*, 39 J. CORP. L. 347, 348 (2014).

⁴⁰ See Crowdfunding, 80 Fed. Reg. 71,387, 71,482 (Nov. 16, 2015).

⁴¹ See Schwartz, *supra* note 39, at 349.

⁴² *Id.* at 354.

⁴³ See *id.*

⁴⁴ James D. Cox, Brainerd Currie Professor of Law, Duke University School of Law, Securities Regulation Class (Feb. 17, 2016).

⁴⁵ Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, LAW & CONTEMP. PROBS., Summer 2000, at 45, 52.

effect of investment analysts and the financial press are two such market forces.

1. Issuer's Reputation

An issuer's concern for its reputation in the market can incentivize the issuer to disclose both accurate information and more information than is required of them under the securities laws. Those issuers who highly value the opinions of investors will be incentivized to make accurate disclosures because "[a] company that misleads investors risks a lower stock price if the fraud is discovered."⁴⁶ Furthermore, one way issuers can separate themselves in the market is by disclosing information demonstrating the high quality of their securities.⁴⁷ Investors also tend to value firms with more publicly disclosed information, so some issuers may even choose to disclose more than required by law. This is particularly important in the current age of technology, where investors can easily find out what information an issuer has disclosed, because once a firm starts disclosing certain additional information, it cannot stop—investors will tend to assume the worst if it does.⁴⁸

2. Investment Analysts and Financial Press

Investment analysts and the financial press also incentivize companies to release accurate information. Large public companies are intensely scrutinized by both investment analysts and the financial press, which "makes fraud much more difficult to execute successfully."⁴⁹ This is especially true in the Internet age, where investors have immediate and relatively costless access to disclosed information, which pressures companies to be even more thorough and timely.⁵⁰

Regulation FD was adopted in August 2000 "as a response to securities issuers' widespread practice of disclosing certain material information directly to industry analysts or institutional investors."⁵¹ Regulation FD tried to curb this behavior by requiring issuers who intentionally disclose material nonpublic information to disclose that information to the public simultaneously.⁵² Regulation FD permits companies to publicly disclose material information through social media

⁴⁶ *Id.*

⁴⁷ See Easterbrook & Fischel, *supra* note 2, at 674.

⁴⁸ See *id.* at 683.

⁴⁹ Langevoort, *supra* note 45, at 52.

⁵⁰ See Coffee, *supra* note 36, at 723.

⁵¹ Sesi Garimella, *Regulation FD and Social Media*, 32 REV. BANKING & FIN. L. 234, 235 (2013).

⁵² See *id.* at 236.

websites.⁵³ However, a company that publicly discloses material information through its social media websites can only escape Regulation FD liability if it simultaneously files a Form 8-K.⁵⁴ The adoption of this filing requirement demonstrates how the expansion of technology has led to an increase in disclosure requirements. The adoption of this filing requirement also demonstrates why it is not always wise to increase disclosure requirements as technology expands. Regulation FD forces companies to act “inconsistent with the manner in which companies and individuals use social media” because it requires them to simultaneously file a Form 8-K every time they update their Facebook status or Tweet.⁵⁵

It is difficult to rationalize increasing reporting requirements when there is an alternative—market forces—that organically leads to the same result: an increase in the amount of thorough and timely information available to investors.

C. Issues Associated with Sharing Proprietary Information with Competitors

Disclosure requirements should be considerate of the competitive concerns associated with sharing proprietary information because “the very information that will enable investors to value the corporation is information that can and will be used by competitors and others to decrease the value of the issuer.”⁵⁶ The SEC has admitted as much when it revised Form 8-K and stated: “Companies may experience some competitive or other strategic costs caused by the requirement to disclose more categories of information more quickly than they otherwise may have chosen to disclose.”⁵⁷

Courts already permit the publication of material information to be delayed for a valuable corporate purpose; in some cases, the corporate purpose being advanced is keeping information from competitors.⁵⁸ Sometimes courts also take into consideration the effect their decisions will have on competition in the markets. For example, in *Asher v. Baxter International, Inc.*, investors of Baxter International claimed that their shares fell \$11 per share as a result of materially misleading projections in November 2001.⁵⁹ Baxter shares fell after it released its second-quarter

⁵³ See *id.* at 243.

⁵⁴ See *id.*

⁵⁵ *Id.*

⁵⁶ Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 848 (1995).

⁵⁷ SEC Release No. 8400, *supra* note 31.

⁵⁸ See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 850 n.12 (2d Cir. 1968).

⁵⁹ See *Asher v. Baxter Int'l, Inc.*, 377 F.3d 727, 728 (7th Cir. 2004).

financial results on July 2002 with sales and profits that did not match analysts' expectations.⁶⁰ The court stated that what the investors wanted was "a full disclosure of the assumptions and calculations *behind* the projections," but held that this would not be a sensible requirement because "[m]any of the assumptions and calculations would be more useful to a firm's rivals than to its investors."⁶¹ A rival can use that information to decrease the value of the firm—" [i]nvestors can have the information, but at a price: their investment will be worth less."⁶²

Some may argue that increasing the requirements for all will balance out any competitive advantage gained by any. However, this argument fails to consider the potential loss of innovation. "[I]n an economy with greater inherent first-mover advantage," innovation and risk-taking occurs more frequently.⁶³ Therefore, when competitive advantage is decreased, firms may be less incentivized to spend time inventing new products and processes because they will not receive the economic benefit that competitive advantage creates. Firms may even choose to abandon profitable projects completely if disclosures are increased because rivals' responses could make the project far less attractive.⁶⁴ Therefore, increasing disclosures could decrease the amount of new products and processes being introduced to the market. It could also drastically increase the amount of time it takes for new products and processes to be created because firms will not invent new processes and products until the costs—which are greater when competitive advantage decreases—outweigh the benefits—which are lesser when competitive advantage decreases.

It is also important to keep in mind that increased disclosure requirements do not just impact domestic issuers vis-à-vis each other, but also impact domestic issuers vis-à-vis foreign issuers. Expanded disclosure requirements can decrease the marketability of U.S. capital markets for foreign issuers and put domestic issuers at a disadvantage because firms that are subject to the U.S. securities laws are forced "to share useful commercial information with all of their competitors," while many of their foreign competitors are not subject to the same requirements.⁶⁵

⁶⁰ *See id.*

⁶¹ *Id.* at 733.

⁶² Kitch, *supra* note 56, at 848.

⁶³ *Id.* at 856.

⁶⁴ *See* Easterbrook & Fischel, *supra* note 2, at 708.

⁶⁵ Kitch, *supra* note 56, at 857.

D. Liability Concerns

The securities laws “impose significant liability for the production of misinformation.”⁶⁶ They make an issuer liable in both private actions and SEC enforcement actions. In SEC enforcement actions, the SEC can seek civil penalties as well as injunctive relief.⁶⁷ Section 12(a)(1) of the Securities Act gives any purchaser a rescission remedy for any violation of section 5.⁶⁸ Section 12(a)(2) gives any purchaser a rescission remedy for a material misstatement or omission in a prospectus while section 11 imposes extensive damage liability on an issuer when there is a material misstatement or omission in their registration statement.⁶⁹ Furthermore, the SEC can bring enforcement actions for fraud under section 17.⁷⁰ The Securities Exchange Act’s Rule 10b-5 imposes both SEC and private liability for material misrepresentations and omissions made in connection with the purchase or sale of any security.

In addition to issuer liability, there are a number of secondary liability provisions that impose liability upon underwriters, directors, control persons, and experts, such as lawyers and accountants.⁷¹ For example, section 11 of the Securities Act imposes extensive damage liability on those associated with a public distribution—absent due diligence—when there is a material falsity or omission in a registration statement.⁷² These actors have come to “expect compensation for the additional liability risk they are forced to assume as well as the additional expenses incurred in carrying out their diligence obligations.”⁷³ It has been calculated that the threat of private civil liability accounts for “a sizable portion of the underwriters’ spread” in the form of a liability risk premium.⁷⁴ This significant regulatory cost is largely borne by investors.⁷⁵

Lawyers and accountants are also exposed to sanctions if they make misstatements directly to investors or “willfully aid an issuer that misleads the investing public.”⁷⁶ The SEC can seek penalties for aiding and abetting

⁶⁶ *Id.* at 770.

⁶⁷ See Securities Act of 1933 § 20, 15 U.S.C. § 77t (2012); Securities Exchange Act of 1934 § 21, 15 U.S.C. § 78u (2012).

⁶⁸ See Securities Act of 1933 § 12(a)(1), 15 U.S.C. § 77l(a)(1) (2012).

⁶⁹ See Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2012); COX ET AL., *supra* note 1, at 485.

⁷⁰ See COX ET AL., *supra* note 1, at 485.

⁷¹ See Langevoort, *supra* note 45, at 51 (issuers do not have the due diligence defense).

⁷² See COX ET AL., *supra* note 1, at 485.

⁷³ *Id.* at 486.

⁷⁴ Langevoort, *supra* note 45, at 45–46.

⁷⁵ See COX ET AL., *supra* note 1, at 486.

⁷⁶ Langevoort, *supra* note 45, at 46.

under both section 15(b) of the Securities Act and section 20(e) of the Securities Exchange Act. Managers are liable in both SEC and private lawsuits if they make misleading statements or if they are deemed part of a control group responsible for fraud.⁷⁷ Both section 15(a) of the Securities Act and section 20(a) of the Securities Exchange Act impose liability on control persons.⁷⁸ Furthermore, under both section 20(e) of the Securities Act and section 21(d)(2) of the Securities Exchange Act, the SEC can prohibit “culpable executives from further serving as an officer or director of a publicly traded corporation.”⁷⁹ It is also important to keep in mind that a criminal prosecution potentially attends the willful violation of any provision of the securities laws (Securities Exchange Act section 32(a)).⁸⁰

These various and expansive liability concerns have become more worrisome since the adoption of Form S-3 (which permits short-form registration for large capitalization issuers) and the expanded availability of shelf registration (which allows for registration without having to issue securities immediately). “Disclosure quality is threatened by the de facto loss of opportunity for external due diligence by underwriters and others associated with the issuance” in these transactions.⁸¹ However, even with the many due diligence challenges these transactions create, the liability provisions are just as strict and unforgiving as for other, much less time sensitive, transactions.

If reporting requirements are further expanded, the already extensive list of liability concerns will increase. This can lead to an undesirable increase in compensations (to parallel the increased liability risk), which would impose an even more significant regulatory cost upon the capital market formation process and ultimately, investors.

E. Doctrinal Issues

There are multiple doctrinal problems with the securities laws that will be exacerbated if the reporting requirements are expanded, including the proper articulation of the duty to disclose. This section focuses on how to articulate the duty of issuers and other participants to update information

⁷⁷ See *id.* at 54.

⁷⁸ See Securities Act of 1933 § 15(a), 15 U.S.C. § 77o(a) (2012) (stating a defense when a control person “had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist”); Securities Exchange Act of 1934 § 20(a), 15 U.S.C. § 78t(a) (2012) (stating a defense when a control person “acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action”).

⁷⁹ Langevoort, *supra* note 45, at 54.

⁸⁰ See COX ET AL., *supra* note 1, at 485.

⁸¹ Langevoort, *supra* note 45, at 46.

and how to articulate their duty to correct information. These issues tie into a discussion of managers' duties under the Management Discussion and Analysis (MD&A) requirement. Another doctrinal issue discussed in this section pertains to ripeness. When do the duties to update and correct arise?

1. Articulating a Duty

The issues that arise in articulating a duty can be seen when analyzing the SEC's duty to update, duty to correct, and MD&A disclosure requirement embedded in Regulation S-K. The Seventh Circuit attempted to define the differences between the duty to update and the duty to correct in *Gallagher v. Abbott Laboratories*.⁸² In *Gallagher*, the Food and Drug Administration (FDA) sent a warning threatening severe consequences to Abbott Laboratories for deficiencies in manufacturing quality control in March 2009.⁸³ By September 1999, the FDA wanted to inflict severe penalties and change Abbott's methods of doing business.⁸⁴ At the end of September, Abbott issued a press release "asserting that Abbott was in 'substantial' compliance with federal regulations."⁸⁵ By November 1999, a court entered a decree requiring Abbott to remove 125 of its products from the market and pay \$100 million in civil fines.⁸⁶

The plaintiffs—buyers of Abbott's securities between March and November 1999—argued that Abbott committed fraud by deferring public revelation.⁸⁷ The court held against the plaintiffs, stating that the plaintiffs never identified any false statement or any statement made misleading by the omission of news about the FDA's demand.⁸⁸ The court stated that under the periodic disclosure system adopted by the SEC, firms do not "have an absolute duty to disclose all information material to stock prices as soon as news comes into their possession."⁸⁹ Under their reasoning, "firms are entitled to keep silent (about good news as well as bad news) unless positive law creates a duty to disclose"—when a firm is issuing securities or is required to file annual or other periodic reports.⁹⁰

The court drew a particularly sharp line between the duty to correct and the duty to update with an example. The court stated that if Abbott's

⁸² *Gallagher v. Abbott Labs.*, 269 F.3d 806 (7th Cir. 2001).

⁸³ *See id.* at 807.

⁸⁴ *See id.*

⁸⁵ *Id.* at 807–08.

⁸⁶ *See id.* at 808.

⁸⁷ *See id.*

⁸⁸ *See id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

10-K report had said that Abbott's net income for 1998 was \$500 million, and the actual income was \$400 million, Abbott would have had to fix the error. But if the 10-K report had projected a net income of \$125 million for the first quarter of 1999, and accountants determined in May that the actual profit was only \$100 million, there would have been nothing to correct; a projection is not rendered false when the world turns out otherwise.⁹¹

Therefore, according to the Seventh Circuit, in a periodic disclosure system, a firm is under a duty to correct unless it is issuing securities, when it is under a duty to update its registration statement and prospectus.⁹²

There are multiple instances in which a company is under a specific duty to correct. When a reporting company makes a statement it later determines is misleading, it must correct that statement if the statement is likely to be material to investors.⁹³ However, it is not always easy to determine what is material to investors. Furthermore, how does one define misleading and how misleading does a statement need to be for it to require correction? These are difficult questions that reporting companies must answer correctly in order to avoid liability.

A reporting company may also be required to correct erroneous rumors leaked by the company itself or its agents.⁹⁴ This duty to correct raises further questions: how many people does a leak need to reach for a company to be under the duty to correct it and how erroneous does the rumor have to be for it to require correction? Furthermore, does an issuer have a duty to correct erroneous rumors or forecasts issued by third parties? *Elkind v. Liggett & Myers, Inc.* provides some clarification as to the last question. The *Elkind* court held that Liggett & Meyers (L&M) had no duty to correct overly optimistic projections and forecasts because they were solely the product of analysts unrelated to L&M.⁹⁵ However, the court did suggest that "had L&M so involved itself with the analysts' published reports that such reports had the expressed or implied endorsement of the company, a duty to correct might have been triggered."⁹⁶ Since *Elkind*, many courts have held issuer's liable for not correcting erroneous statements leaked by analysts when they were overly involved in the reports.⁹⁷ However, the question remains as to how much involvement an issuer must have for the issuer to be under a duty to correct.

⁹¹ *Id.* at 810.

⁹² *See id.*

⁹³ *See* EISENBERG & COX, *supra* note 4, at 877.

⁹⁴ *See id.*

⁹⁵ *See* *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 164 (2d Cir. 1980).

⁹⁶ COX ET AL., *supra* note 1, at 729.

⁹⁷ *See id.*

Lastly, reporting companies may also be liable for omitted information if keeping this information private makes the information that is public materially false.⁹⁸ Determining when privately kept information causes public information to be materially false can be a difficult task.

There are just as many questions concerning the duty to update as there are concerning the duty to correct. However, articulating the duty to update is made even more difficult by the MD&A section of SEC filings, which is set forth in Item 303 of Regulation S-K.⁹⁹ The MD&A section requires “management to provide narrative explanations of the financial statements” with the purpose of both increasing transparency and providing better disclosure to investors.¹⁰⁰

Panther Partners Inc. v. Ikanos Communications, Inc. demonstrates how management may find it difficult to determine what they are required to include in the MD&A section of their filing.¹⁰¹ In *Panther Partners*, Ikanos Communications Inc. made 72% of its 2005 revenues by selling its VDSL Version Four chips to two of its largest customers—Sumitomo Electric and NEC.¹⁰² In January 2006, Ikanos learned that there were quality issues with the chips and during the weeks leading up to Ikanos’s March secondary offering of its securities, Ikanos received an increasing number of complaints about the chips from Sumitomo Electric and NEC.¹⁰³

Three months after the secondary offering, Ikanos reached an agreement with Sumitomo Electric and NEC—it replaced all of the units it had sold (not just the defective ones) at its own expense.¹⁰⁴ Thus, Ikanos had to report a \$2.2 million net loss for the second quarter, causing its stock to drop over 25%.¹⁰⁵ Plaintiffs brought suit as a putative securities class action, alleging in part that disclosures in Ikanos’s offering statement and registration statement for the secondary offering were inadequate and in contravention of Item 303.¹⁰⁶ Plaintiffs alleged “that Ikanos did not disclose the magnitude of the defect issue in either the” registration statement or the prospectus—it simply cautioned in generalized terms.¹⁰⁷

The court stated that the SEC’s interpretative release regarding Item 303 clarifies that the “the Regulation imposes a disclosure duty ‘where a

⁹⁸ See EISENBERG & COX, *supra* note 4, at 877–78.

⁹⁹ See COX ET AL., *supra* note 1, at 606.

¹⁰⁰ *Id.*

¹⁰¹ *Panther Partners Inc. v. Ikanos Commc’ns, Inc.*, 681 F.3d 114 (2d Cir. 2012).

¹⁰² *See id.* at 116.

¹⁰³ *See id.*

¹⁰⁴ *See id.* at 117.

¹⁰⁵ *See id.*

¹⁰⁶ *See id.*

¹⁰⁷ *Id.*

trend, demand, commitment, event or uncertainty is both [1] presently known to management and [2] reasonably likely to have material effects on the registrant's financial condition or results of operations.”¹⁰⁸ The court held that the plaintiffs’ complaint plausibly alleged this because not only was Ikanos receiving an increasing number of calls regarding the defect from key customers, but the Board of Directors was discussing the issue, Ikanos “was aware of the ‘uncertainty’ that it might have to accept returns of a substantial volume, if not all, of the chips,” and Ikanos’s representatives were meeting with Sumitomo Electric and NEC.¹⁰⁹

Although *Panther Partners* seems to be a more clear-cut case than most, its definition of what must be included in an MD&A is open to interpretation because it can be difficult for a company to determine the parameters of reasonably likely and material in certain situations.

2. Ripeness

The second doctrinal issue is determining ripeness: when do the duties to update and correct arise? *Matrixx Initiatives, Inc. v. Siracusano* demonstrates the ripeness issues that arise in SEC filings.¹¹⁰ In *Matrixx*, the respondents, who were plaintiffs in a securities fraud class action against Matrixx Initiatives, Inc., alleged that petitioners failed to disclose reports of a possible link between its leading product Zicam Cold Remedy—which accounted for 70% of Matrixx’s sales—and loss of smell.¹¹¹

“Respondents allege[d] that Matrixx made a series of public statements that were misleading in light of the [following] information.”¹¹² In October 2003, shortly after two doctors presented their findings of a possible link between Zicam and a loss of smell at a meeting of the American Rhinologic Society (ARS), “Matrixx stated that Zicam was ‘poised for growth in the upcoming cough and cold season’ and that the company” expected revenues to “be up in excess of 50%.”¹¹³ In its November 2003 Form 10-Q, Matrixx stated that product liability actions could materially affect Matrixx but it did not disclose that two plaintiffs who had lost their sense of smell after using Zicam had already sued Matrixx.¹¹⁴ Furthermore, Matrixx released a press release stating that it

¹⁰⁸ *Id.* at 120 (citing Management’s Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 6835, Exchange Act Release No. 26,831, Investment Company Act Release No. 16,961, 1989 WL 1092885, at *6 (May 18, 1989)).

¹⁰⁹ *Id.* at 121.

¹¹⁰ *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27 (2011).

¹¹¹ *See id.* at 30–31.

¹¹² *Id.* at 33.

¹¹³ *Id.* at 32–33.

¹¹⁴ *See id.* at 34.

believed “statements alleging that intranasal Zicam products caused [loss of smell we]re completely unfounded and misleading.”¹¹⁵ Based on these allegations, the “respondents claimed that Matrixx violated § 10(b) of the Securities Exchange Act and SEC Rule 10b–5 by making untrue statements of fact and failing to disclose material facts necessary to make the statements not misleading.”¹¹⁶

Respondents had to “show that [petitioners] made a statement that was ‘misleading as to a material fact’” in order to prevail on a section 10(b) claim.¹¹⁷ The Court applied the *TSC Industries* standard of materiality—in order to meet the materiality requirement there must be “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”¹¹⁸ To meet this standard, something more is needed than mere reports of adverse events.¹¹⁹ The Court stated that this something more does not have to be statistically significant data.¹²⁰ It “can come from ‘the source, content, and context of the reports.’”¹²¹

When the Court applied the “total mix” standard to Matrixx, it concluded that respondents adequately pleaded materiality.¹²² Matrixx not only received reports from medical professionals about patients losing their sense of smell after using Zicam,¹²³ but “two plaintiffs had already sued Matrixx for allegedly causing them to lose their sense of smell,”¹²⁴ Matrixx was aware of the ARS presentation, and medical researchers had drawn Matrixx’s attention to studies demonstrating a link between intranasal use of zinc and loss of smell.¹²⁵ The Court concluded that it was “substantially likely that a reasonable investor would have viewed this information ‘as having significantly altered the “total mix” of information made available.’”¹²⁶

In *Matrixx* the Court applied the *TSC Industries* standard of materiality in the section 10(b) and Rule 10b–5 context. The Supreme Court applies this standard in “[v]irtually all cases involving materiality

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 36.

¹¹⁷ *Id.* at 38 (emphasis omitted) (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988)).

¹¹⁸ *Id.* (quoting *Basic*, 485 U.S. at 231–32).

¹¹⁹ *See id.* at 44.

¹²⁰ *See id.* at 36–37, 40.

¹²¹ *Id.* at 44.

¹²² *Id.* at 45.

¹²³ *See id.*

¹²⁴ *Id.* at 34.

¹²⁵ *See id.* at 45–46.

¹²⁶ *Id.* at 47 (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988)).

determinations under the federal securities laws.”¹²⁷ However, this standard leaves many questions unanswered: how does one define a substantial likelihood? How does one define the reasonable investor? And finally, what does it mean to significantly alter the total mix of information made available? Reporting companies are under extreme pressure to answer these questions correctly because of the potential for liability.

The *TSC Industries* materiality standard only applies to historical facts—it does not apply in cases where the materiality of a misstatement or omission concerning a merger is being analyzed, because these types of cases concern a fact uncertain of occurrence or, in other words, a speculative fact. *Basic Inc. v. Levinson* articulated the materiality standard for speculative facts. In *Basic*—which concerned a merger between Basic Inc. and Combustion Engineering, Inc.—the Supreme Court held that the materiality of a speculative fact depends on the

“probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.” . . . [I]n order to assess the probability that the event will occur, a factfinder will need to look to indicia of interest in the transaction at the highest corporate levels. . . . To assess the magnitude of the transaction . . . , a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value.”¹²⁸

What level of interest in the transaction at the highest corporate levels must be met to meet this standard? Furthermore, how is “highest corporate levels” defined? How large do the two corporate entities have to be to meet this standard and how large do the potential premiums over market value have to be? These questions demonstrate that the *TSC Industries* standard is not the only materiality standard that leaves many questions unanswered.

The materiality defenses—truth on the market, puffery, statement of opinion, and forward-looking statements—create an extra wrinkle in any ripeness analysis. These defenses permit a court to dismiss a materiality claim at pre-trial, thus saving a corporation from having to spend the time, money, and energy on a full fledged trial before a jury. The truth on the market defense applies if there is enough information in the market for investors to deduce the statement is misleading.¹²⁹ What information must be in the market such that the truth on the market defense should apply? The parameters of this question are still ill-defined.

¹²⁷ COX ET AL., *supra* note 1, at 620.

¹²⁸ *Basic*, 485 U.S. at 238–39 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968)).

¹²⁹ *See Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 516 (7th Cir. 1989).

The second defense—puffery—applies to “ambiguous, promotional, or hyperbolic speech commonly known as ‘sales talk.’”¹³⁰ In 2008 an investor survey was conducted in which 33-84% of reasonable investors surveyed deemed statements material that had been held by a court to be puffery.¹³¹ Clearly, defining when and under what circumstances reasonable investors will expect puffery is not as clear-cut and well-defined as courts seem to think it is.

Related to the puffery defense, is the defense that a statement is not material because it is a statement of opinion. In *Virginia Bankshares, Inc. v. Sandberg*, the court concluded that a statement of opinion can “fall within the standard strictures of the antifraud provisions.”¹³² However, it never addressed whether statements of opinion can relate to material facts.¹³³ This question was answered in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*.¹³⁴ In *Omnicare*, the Supreme Court held that a plaintiff

investor must identify particular (and material) facts going to the basis for the issuer’s opinion—facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have—whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context.¹³⁵

Under this approach, opinions can be material and cases concerning them should be analyzed as omission cases. Therefore, when confronted with the statement of opinion defense, the same issues and questions that arise in omission cases will arise in these types of cases.

As to the forward-looking statements defense, a statutory safe harbor in the Securities Exchange Act section 21E coexists with the bespeaks caution doctrine. The statutory safe harbor applies if the forward-looking statement is immaterial, surrounded by meaningful cautionary language, or the plaintiff fails to prove that the misleading forward-looking statement was made with actual knowledge.¹³⁶ The bespeaks caution

¹³⁰ Stefan J. Padfield, *Is Puffery Material to Investors? Maybe We Should Ask Them*, 10 U. PA. J. BUS. & EMP. L. 339, 340 (2008) (citing Jennifer O’Hare, *The Resurrection of the Dodo: The Unfortunate Re-Emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697, 1698 (1998)).

¹³¹ *See id.* at 341.

¹³² COX ET AL., *supra* note 1, at 641.

¹³³ *See generally* *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991).

¹³⁴ *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318 (2015).

¹³⁵ *Id.* at 1332.

¹³⁶ *See* Securities Exchange Act of 1934 § 21E(c), 15 U.S.C. § 78u-5(c) (2012).

doctrine, which deems a forward-looking statement not material if it is surrounded with meaningful cautionary language,¹³⁷ applies to statements made in connection with transactions which the statutory safe harbor does not cover.¹³⁸ It can be difficult for a corporation to determine what causes cautionary language to be deemed meaningful.

Clearly there are just as many doctrinal issues associated with determining when the duty to disclose arises as there are when articulating the duty to disclose itself. All of these existing doctrinal issues will only be exacerbated if the reporting requirements are expanded.

CONCLUSION

Advancements in information technology have created a world where large amounts of data can be rapidly collected, analyzed, and presented at lower costs and in less time than in the not too distant past. Therefore, while the reason for requiring reporting in ninety-day increments was understandable in a paper-based reporting system, that justification is no longer reasonable. However, technological prowess should not be the only consideration when determining the optimal points in time for companies to disclose their performance to markets. This paper set forth five arguments that oppose the expansion of, and even support the reduction of, reporting requirements: expanded requirements are associated with high compliance costs; market forces already induce higher-quality disclosures; the more proprietary information a company shares with its competitors, the more its competitive advantage decreases; and both the liability concerns and the doctrinal issues already associated with the current reporting requirements will only be exacerbated with an increase in requirements.

¹³⁷ See *In re Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig.*, 7 F.3d 357, 371–72 (3d Cir. 1993).

¹³⁸ See Securities Exchange Act of 1934 § 21E(b), 15 U.S.C. § 78u-5(b) (2012).