The SEC's Unfinished Soft Information Revolution

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INTRODUCTION

The transformation of the Securities and Exchange Commission's mandatory disclosure system represents the single most important development in the agency's greater than sixty years' experience administering disclosure requirements. Since the early 1970s, the SEC has shifted its emphasis from historical or "hard" information to its current emphasis on forward-looking information. This transformation can be termed the "soft information revolution" in the SEC's mandatory disclosure system. In terms of investor protection, the SEC's emphasis on forward-looking information has significantly improved the quality of what is mandatorily disclosed.

The SEC has developed standards, buttressed by a single, limited safe harbor rule, regarding prospective statements. The development of several different hortatory and mandatory standards, however, has led to complexities in the enforcement of the Commission's forward-looking rules and guides. In October 1994, the Commission acknowledged these complexities when it issued a concept release and announced public hearings on current practices relating to the disclosure of forward-looking information.

This Article examines the SEC's approach to disclosure of forward-looking statements, and suggests that the SEC issue an interpretative

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1. There is a substantial literature concerning soft information or forward-looking statements. For relevant citations, see 2 Louis Loss & Joel Seligman, Securities Regulation 622 n.66 (3d ed. 1989).
3. 17 C.F.R. §§ 230.175, 240.3b-6 (1994).

In the concluding substantive paragraphs of this release, the Commission may have invited discussion of legislative proposals. Id. at 85,792-93. Subsequently, SEC Chairman Levitt indicated that he would prefer not to seek new legislation to address private securities litigation at this time. Levitt Says No Plans to Seek Legislation to Reform Litigation, 26 Sec. Reg. & L. Rep. (BNA) No. 44, at 1503 (Nov. 11, 1994).

This Article is limited to analysis of SEC administrative approaches to problems posed by forward-looking statements. Elsewhere, I have addressed the merits of several legislative proposals that were introduced in the 103d Congress. Joel Seligman, The Implications of Central Bank, 49 Bus. Law. 1429, 1445-46 & n.92 (1994).
release to guide registrants in this arena. Part I of this Article considers the evolution of the Commission's current rules and guides with respect to prospective statements. Part II addresses the disclosure of risk factors and assumptions to accompany forward-looking statements. This part first discusses the judiciary's approach to such disclosure through application of the bespeaks caution doctrine. This part then suggests that the Commission issue a detailed interpretative release similar to releases it has issued with respect to municipal securities. Such a release would outline how issuers and registrants might, in various specified circumstances, disclose the risks and assumptions underlying forward-looking statements. This part also identifies other approaches that the SEC might adopt to guide issuers and registrants with respect to prospective statements and argues that these alternatives are inferior to an interpretative release.

I. THE COMMISSION’S FORWARD-LOOKING STATEMENT RULES AND GUIDES

A. Hortatory Forward-Looking Statements

The Commission currently "encourages ... management's projections of future economic performance that have a reasonable basis and are presented in an appropriate format." As exhorted in Item 10(b) of Regulation S-K, such projections or forward-looking statements include a list of statements in specified documents:

1. A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;
2. A statement of management's plans and objectives for future operations;
3. A statement of future economic performance contained in management's discussion and analysis of financial condition and results of operations included pursuant to Item 303 of Regulation S-K . . . or Item 9 of Form 20-F; or


6. 17 C.F.R. § 229.10(b) (1994).
(4) Disclosed statements of the assumptions underlying or relating to any of the statements described in paragraphs (c) (1), (2), or (3) of this section.7

Before 1972, the Commission generally prohibited the inclusion of projections in filings under the 1933 and 1934 Acts.8 There were three, somewhat overlapping, bases for this exclusionary policy. First, the Commission assumed that the relevant constituency for its documents was the unsophisticated investor.9 According to the Commission’s 1977 report by the Advisory Committee on Corporate Disclosure (popularly known as the “Sommer Report”), the need to protect unsophisticated investors outweighed the disclosure objective of supplying the investment community with meaningful information.10 Thus, the Commission justified the exclusion of projections as necessary to prevent undue investor reliance or managerial manipulation. Second, projections were sometimes characterized as not involving “facts” and as inherently unreliable.11 Third, paradoxically, investors were characterized as being just as competent as managers to make projections.12 Harry Heller, a senior Commission attorney, memorably articulated the last two points in a 1961 law review article:

As early as 1904 Veblen expressed the view that the value of an investment basically is a function of future earning power. . . .

The question will be raised, if the determination of future earnings is the prime task confronting the investor, why not require or permit a direct prediction of such earnings? The answer to this is

7. 17 C.F.R. §§ 230.175(c), 240.3b-6(c) (1994).
8. Several exceptions, generally for unfavorable information, developed over time. By 1972, one commentator noted that the Commission “had required negative disclosures, for example, on such topics as plant efficiency, management integrity, labor relations, pending antitrust negotiations with the Justice Department, anticipated changes in a company’s competitive position, or trends reflected in recent interim earnings, topics on which favorable disclosures would probably be prohibited.” Carl W. Schneider, Nits, Grits, and Soft Information in SEC Filings, 121 U. Pa. L. Rev. 254, 262 (1972) (footnotes omitted); see id. at 260-63.
10. Id. See generally id. at 347-65 (outlining the reasons for requiring disclosure in general and the use of management projections in particular). Concern that “projections . . . would be accorded a greater measure of validity by the unsophisticated than they would deserve” persuaded the Wheat Disclosure Policy Study “that the Commission’s policy on projections should not be changed.” SEC, Disclosure to Investors: A Reappraisal of Federal Administrative Policies under the ‘33 and ‘34 Acts 96 (1969).
12. Id.
that the Securities Act, like the hero of "Dragnet", is interested exclusively in facts. Conjectures and speculations as to the future are left by the Act to the investor on the theory that he is as competent as anyone to predict the future from the given facts. Since an expert can speak with authority only as to subjects upon which he has professional knowledge and since no engineering course or other professional training has ever been known to qualify anyone as a clairvoyant, attempts by companies to predict future earnings on their own or on the authority of experts have almost invariably been held by the Commission to be misleading because they suggest to the investor a competence and authority which in fact does not exist.\textsuperscript{13}

On these bases, the Commission, in essence, took the view that projections were per se misleading and so stated in a note to one of its proxy rules.\textsuperscript{14}

By the early 1970s, the Commission's exclusionary policy was being severely criticized. One influential critic was Professor Homer Kripke. In a 1970 law review article, Kripke dismissed the Commission's policy as "nonsense."\textsuperscript{15} While noting that most large corporations base important business decisions on projections, Kripke urged that the public is less able than large companies to understand "the meaning, results and implications" of projections.\textsuperscript{16}

With the widespread belief that an "efficient market" in information dissemination operated, however, concern that unsophisticated investors would attach undue credence to projections was difficult to sustain. Unsophisticated investors received much of their firm-specific data "second-hand," that is, filtered through brokers aided by firm research departments and investment advisers. Alternatively, these investors used market professionals, such as institutional investors, to invest for them. In either case, the weight an unsophisticated investor was likely to attach to a forecast would be determined by a professional investor. Moreover, deliberate management manipulation of forecasts could be policed by securities fraud liability rules.

Thus, a more realistic fear, argued Kripke, was that by prohibiting disclosure of earnings projections, the Commission had perpetuated a form of differential disclosure.\textsuperscript{17} "Under its present system," Kripke wrote, "the SEC precludes the giving of this information equally to all investors through the documents filed with it."\textsuperscript{18} While the average

\textsuperscript{13. Id. at 304, 307 (citation omitted).
\textsuperscript{16. Id. at 1198.
\textsuperscript{17. Id. at 1199.
\textsuperscript{18. Id.}
investor was precluded from receiving management projections, professional investors informally obtained them through such media as press conferences and speeches. 19

Nor did Kripke believe that the danger of management exaggeration of future earnings prospects posed a major problem. If there was a rational basis for a forecast and if managerial "good faith" was required, "[t]he SEC staff would have no difficulty dealing with unreasoned or unduly optimistic projections of promotional companies, any more than it did in the early 1930s or even today with unsound estimates of mineral resources." 20 Kripke concluded:

The importance of this point on projections cannot be overestimated. If there is any hope that the public or even the professionals can make an informed investment judgment, it must start from a crystallization of all of the plethora of information into a projection for the future. The management is in the best position to make the initial estimate; on the basis of it the professional or investor could then make his own modifications. No other single change could add as much meaning to the unmanageable and unfocussed flood of facts in present Commission documents. 21

Soon after beginning his chairmanship, William Casey persuaded the Commission to hold a public rulemaking proceeding to review the policy barring publication of projections. 22 In particular, Chairman Casey appeared to be impressed by the British practice of including earning forecasts in prospectuses and certain other public documents. 23 The Commission held hearings in November and December 1972. In February 1973, the Commission published a "Statement on the Disclosure of Projections of Future Economic Performance," indicating that the agency planned to move toward integrating projections into the disclosure system, although it would not require issuers either to develop or to disclose projections. 24

In April 1975, the Commission published a detailed series of proposals to implement its February 1973 statement on projections. 25 These proposals defined a projection as "a statement made by an is-

19. Id.
20. Id.
21. Id.
23. See id.
suer regarding material future revenues, sales, net income or earnings per share of the issuer, expressed as a specific amount, range of amounts ... or percentage variation from a specific amount ... , or a confirmation by an issuer of any such statement made by another person.”

The proposed safe harbor rule provided that a projection would be deemed not to be fraudulent, whether or not the projection was achieved, if certain criteria were met at the time the projection, in substance, was made. Specifically, the proposal required the issuer to have registered securities, to have been subject to reporting requirements for at least three years, and to have complied with those requirements in the past twelve months. The proposed rule further required that the issuer had prepared internal budgets for the preceding three fiscal years. Moreover, the projection must meet specific criteria. Most notably, it must have been (1) made in good faith; (2) “prepared with reasonable care by qualified personnel and carefully reviewed and approved by management at the appropriate levels”; and (3) identified as a projection. The proposal also mandated that the registrant publicly disclose all projections furnished to anyone other than a government agency. Finally, the proposal required the registrant to revise any projection previously filed once it no longer had a reasonable basis or briefly explain why it could not do so.

The Commission’s April 1975 report drew an unusually large number of comment letters, virtually all of which opposed the proposals. As summarized in an appendix to the Sommer Report, there were four primary grounds for opposition. First, opponents argued that the complexity of the proposed disclosure system would discourage voluntary compliance. Specifically, these critics pointed to the substantial costs that registrants would incur. Second, critics contended that the term “projection” needed further definition. The definition was so vague, they argued, “that registrants [often] would not know if a reportable event had occurred.” Third, opponents believed that few registrants would bear the risks of the proposed safe harbor. Specifically, “[t]he subjective standards of ‘reasonable care,’ ‘qualified personnel,’ ‘carefully reviewd [sic] and approved,’ ‘appropriate levels,’ ‘reasonable factual basis,’ and ‘good faith judgment’ invited litiga-

26. Id. at 85,302.
28. Id.
29. Id. at 755.
30. Id. at 756.
31. Id.
32. Sommer Report, supra note 9, app. at 291.
33. Id. app. at 291-92.
34. Id. app. at 292.
Finally, registrants threatened to limit the flow of information to the investment community if the proposals were adopted.36

The concern about "inviting litigation" was expressed with particular fervor in light of a number of cases decided in the years immediately preceding the Commission's April 1975 proposals. In one case, brought under section eleven of the Securities Act of 1933, the court held that a registration statement filed in connection with a takeover bid should have disclosed the target insurance company's "surplus surplus"—that is, the surplus in excess of the amount required by the state insurance authorities.37 The court rejected the argument that the estimates were too unreliable, reasoning that the surplus surplus was one of the principal reasons for the takeover attempt.38 In another case, the court rejected a complaint against a chemical company because the shortfall resulted from a recession that had hit synthetic fiber producers with particular impact.39 Furthermore, the company had carefully developed internal forecast figures that were consistent with the published figures, and the published forecast had fit into a continuing framework of regular dissemination of company news, good or bad.40 A third case supported the worst expectations of those who opposed forecasts as legally dangerous.41 In that case, the court held that a projection of income was false if it was not "highly probable" that the predicted breakeven income level would be realized.42 The court also found, however, that there was no recklessness as required by rule 10b-5 as long as there was some basis for the prediction.43

In April 1976, the Commission withdrew its proposed rules on projections "[d]ue to the important legal, disclosure policy and technical issues raised by the commentators."44 Instead, the agency proposed substantively identical Guides 62 (under the Securities Act) and 4 (under the Exchange Act) outlining the views of the Division of Cor-

35. Id.
36. Id. app. at 293. A 1972 study reported that more than 97% of the responding companies prepared sales, expense and earnings forecasts, but that all companies expressed concern over the consequences of releasing their internal figures. Financial Executive Research Foundation, Public Disclosure of Business Forecasts (1972).
38. Id. at 579.
40. Id. at 686.
42. Id. at 98,536.
43. Id.
poration Finance on projections. The full Commission continued to adhere to the position that it would neither encourage nor discourage forecasts. The Commission added, nevertheless, that it would not object to good faith projections that had a reasonable basis and an appropriate format and were accompanied by information adequate to enable investors to make their own judgments. The Commission also articulated its belief that appropriate projections should not create civil liability simply because they turn out to be erroneous.

Subsequently, the Sommer Advisory Committee on Corporate Disclosure urged that "the Commission should issue a public statement encouraging companies to disclose voluntarily management projections in their filings with the Commission and elsewhere. In order to maximize the attractiveness of the program to registrants, the Committee's recommendation permits wide latitude to companies issuing projections." Among other points, the Sommer Report recommended that (1) all public companies be eligible to make projections; (2) disclosure of underlying assumptions be encouraged, not required; (3) managers not be required to explain ex post facto the variance of actual results from projections; (4) there be no requirements as to the specific items to be projected; and (5) the Commission adopt a safe harbor rule for "management projection of future company economic performance . . . unless such information: (1) [w]as prepared without a reasonable basis; or (2) [w]as disclosed other than in good faith."

The Sommer Report recognized that the fundamental issue with respect to projections was whether they should be permissive or mandatory. It offered four reasons why a voluntary projection system was preferable. First, a period of experimentation with a voluntary system was desirable before a mandatory rule was adopted. Second, for certain companies, the fiscal and administrative burdens of projection disclosure might outweigh the benefits. Third, corporations were concerned that they would be liable for inaccurate pro-

45. Id.
46. Id.
47. Id. at 86,200-01.
48. Id. at 86,202.
49. Sommer Report, supra note 9, at 353 (footnote omitted). See generally id. at ch. X (detailing recommendations that would transform the Commission into a more forward-looking body).
50. The Report specifically declined to limit its recommendation to those companies with a record of filing in the 1934 Act continuous disclosure system. Id. at 356-57.
51. Id. at 357.
52. Id. at 358.
53. Id. at 358-61.
54. Id. at 362.
55. Id. at 364.
56. Id. at 354-55, app. at 318.
57. Id. at 354.
58. Id.
jections. Finally, the Report observed, “a lack of operating history, general economic factors or industry conditions” might effectively prevent many companies from preparing reasonable projections.

The Commission was generally persuaded by the analysis of the Sommer Report. In late 1978, it authorized publication of the Division of Corporation Finance’s Guides on “Disclosure of Projections of Future Economic Performance,” and prepared alternative versions of a safe harbor rule. In mid-1979, to encourage projections, the Commission adopted safe harbor rules under the 1933 and 1934 Acts, to the effect that a forward-looking statement is not fraudulent unless the plaintiff proves a lack of reasonable basis or lack of good faith. Although the rules as proposed for comment would have put the burden of proof with respect to reasonableness and good faith on the defendant, the Commission deferred to the recommendation of the Sommer Report and imposed the burden on the plaintiff.

As part of its integrated disclosure release in 1982, the Commission rescinded the Division of Corporation Finance’s “Guides for Disclosure of Projections of Future Economic Performance” and relocated their substance in Item 10(b) of Regulation S-K. Like the Guides, Item 10(b) is hortatory. It encourages management to make projections, requires management to have a reasonable basis for its assessment of a registrant’s future performance and grants management broad discretion as to how a reasonable basis for such an assessment is to be assembled. If an outside review of management’s projections is included in a Commission filing (again, a matter of management

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59. Id.
60. Id.
66. 17 C.F.R. § 229.10(b) (1994).
discretion), the reviewer's qualifications, the extent of its review, and its relationship to the registrant must be disclosed. If the review is included in a registration statement under the 1933 Act, the reviewer is deemed an expert and an appropriate consent must be filed with the registration statement.

The Commission does not limit the items about which a projection may be made, but it does caution management to avoid misleading investors through selective projection of only favorable items. Management may choose the period for a projection and whether the projection is the most probable specific amount or a reasonable range. Managers are encouraged, but not required, to indicate their intentions to update projections, to disclose their assumptions, and to present the projections in a format that will facilitate subsequent analysis of the reasons for differences between actual and forecast results. Managers further are discouraged from discontinuing or resuming projections without a reasonable basis.

B. Mandatory Forward-Looking Statements

When the Advisory Committee on Corporate Disclosure endorsed a voluntary approach to the disclosure of forward-looking statements, its chairman, A. A. Sommer, was among those not entirely convinced by the Committee's arguments. Elsewhere Sommer wrote:

Lurking in the Advisory Committee's conclusion that issuers should be encouraged to publish soft information is a strange and troubling anomaly. The Committee's recommendation appears to be premised on the conclusion that such information is important to investors, important enough that issuers should be pressed to disclose it. Yet the Committee recoiled from making such disclosure mandatory. With respect to information demonstrably less important to decision making than forecasts, for example, compensation to top officers, the Commission had not refrained from laying down a flat requirement of disclosure. The Committee equivocated, and the Commission continues to equivocate, with respect to "soft" information. Eventually the Commission will have to face up to this inconsistency and the consequences of recognizing the materiality of such information.

67. Id.
68. Id.
69. Sommer Report, supra note 9, at 362.
70. Id. at 361-62.
71. Id. at 359-60.
72. Id. at 358.
73. Id. at 365-74.
74. Id. at 362.
At no time since the adoption of the SEC's safe harbor rules has there been a high level of voluntary publication of forward-looking information. The Commission, in essence, has responded to the "troubling anomaly" implicit in the low levels of compliance with its hortatory Item 10(b) by adopting several mandatory forward-looking statement requirements, including those discussed in the balance of this part.

1. Environmental Compliance Costs

Item 101(c)(xii) of Regulation S-K requires each registrant to disclose the material effects that compliance with federal, state and local provisions relating to the protection of the environment may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries. Specifically, the Item provides: "The registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem materials [sic]."

The Commission initially adopted this standard in 1973 to comply with the National Environmental Policy Act. Subsequently, the Natural Resources Defense Council challenged this standard, in part because the Commission had denied the its petitions for other requirements concerning corporate environmental and equal employment practices. After protracted litigation, the Commission's denial of the NRDC's proposals ultimately was approved. The court reasoned that Congress granted the Commission broad discretionary powers, and that the Commission had no obligation to adopt the proposals of the NRDC.

In Levine v. NL Industries, Inc., the Second Circuit interpreted Item 101(c)(1)(xii) to require disclosure of both the cost of compliance with environmental regulations and potential costs for failure to

76. See, e.g., The Conference Board, Public Disclosure of Corporate Earnings Forecasts 7 (Rep. 804 1981) (reporting that although only 42 of 405 corporate participants in a study have ever revealed their forecasts to outsiders, a majority nevertheless provided assistance to financial analysts in preparing the analysts' projections); Douglas J. Skinner, Why Firms Voluntarily Disclose Bad News, 32 J. Acct. Res. 38, 38 (1994) ("[C]onsistent with prior studies, earnings-related voluntary disclosures occur infrequently (on average, one disclosure for every ten quarterly earnings announcements.").

77. 17 C.F.R. § 229.101(c)(xii) (1994).
78. Id.
80. Natural Resources Defense Council, Inc. v. SEC, 606 F.2d 1031 (D.C. Cir. 1979) [hereinafter NRDC].
81. Id. at 1062; see Sommer Report, supra note 9, at 393.
82. NRDC, 606 F.2d at 1045.
83. 926 F.2d 199 (2d Cir. 1991).
In so doing, the court followed the SEC's stated intention that disclosure of such costs be required.\textsuperscript{85}

2. Legal Proceedings

Item 103 requires a brief description of any material pending legal proceeding, other than ordinary routine litigation.\textsuperscript{86} The instructions to Item 103 provide some guidance concerning ordinary negligence claims;\textsuperscript{87} damages claims;\textsuperscript{88} bankruptcy, receivership, or similar proceedings;\textsuperscript{89} derivative litigation;\textsuperscript{90} and environmental proceedings.\textsuperscript{91}

Nonetheless, the very breadth of this Item has given rise to interpretative questions. In 1988, the Commission published an interpretative release reminding companies of their disclosure obligations in connection with issues arising from the government's defense contract procurement inquiry.\textsuperscript{92} With respect to disclosure of material pending legal proceedings involving a company or its subsidiaries, the Commission observed:

Legal proceedings known to be contemplated by government agencies similarly should be disclosed where management reasonably believes that such government action will have a material effect upon the company and its business. In this regard, disclosure of known contemplated government proceedings may be required where the result may be the cancellation of a government contract, suspension of payments under a contract, termination of further business with the government, or alterations of the registrant's procedures for obtaining government contracts.\textsuperscript{93}

The Commission further observed that disclosure obligations could arise under several other Regulation S-K Items, such as Item 101 (Description of Business) or Item 303 (Management's Discussion and Analysis of Financial Condition and Results of Operations).\textsuperscript{94}

Instruction 5C to Item 103 requires disclosure of environmental proceedings when a government authority is a party and the proceeding involves potential monetary sanctions, unless the registrant reasonably believes that the monetary sanctions, exclusive of interest and

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  \item \textsuperscript{84} Id. at 203-04.
  \item \textsuperscript{85} Id. (citing \textit{In re United States Steel Corp.}, Exchange Act Release No. 16,223 [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) \textsection 82,319, at 82,384 (Sept. 27, 1979)).
  \item \textsuperscript{86} 17 C.F.R. \textsection 229.103 (1994).
  \item \textsuperscript{87} Id. instruction 1.
  \item \textsuperscript{88} Id. instruction 2.
  \item \textsuperscript{89} Id. instruction 3.
  \item \textsuperscript{90} Id. instruction 4.
  \item \textsuperscript{91} Id. instruction 5.
  \item \textsuperscript{93} Id. at 62,126.
  \item \textsuperscript{94} Id.
costs, will be less than $100,000. In In re United States Steel Corp., the Commission found that a corporation failed to disclose the material effects that compliance with environmental laws would have on capital expenditures and earnings and failed to disclose a series of pending or contemplated environmental administrative proceedings when it stated in its filings, “U.S. Steel had pledged to confront and resolve its environmental problems as effectively and efficiently as technology, time and money permit.” The Commission noted that U.S. Steel detailed neither its policy nor the risks of noncompliance.

More broadly, Item 103 does not define materiality. The Commission has long distinguished "quantitative" from "qualitative" materiality. The concept of quantitative materiality typically involves a percentage of a corporation’s assets, earnings, sales, or other numerical benchmarks. While the percentage may vary with the context of a rule or proceeding, and judgments often must be made about the potential economic effects of a transaction or occurrence when the immediate percentage is beneath the relevant threshold, the concept of quantitative materiality is reasonably straightforward.

The Commission, however, long has recognized that in some circumstances involving matters such as managerial conflicts of interest or violations of law, there should be disclosure even when the relevant transaction or occurrence would not be quantitatively material. These instances of "qualitative" materiality typically involve questions concerning the integrity or ability of management. The extent to which events involving qualitative materiality should be disclosed is a problem that long has defied neat solution.

95. 17 C.F.R. § 229.103 instruction 5(c) (1994).
97. Id. at 82,381 (quoting U.S. Steel Co.’s filings).
98. Id. at 82,384.
99. The Sommer Report concluded, "Both as articulated by the courts and as set forth in Commission rules, the definition [of materiality] is not readily translatable into objective criteria." Sommer Report, supra note 9, at 321 (footnote omitted).
100. See, e.g., 17 C.F.R. § 229.103 instruction 2 (1994) (stating that the amount involved in proceedings shall be included in computing such percentage).
3. Contingent Liabilities

Since December 1973, when the Commission issued Accounting Series Release No. 150, which normally requires financial statements to be prepared in accordance with the “principles, standards, and practice promulgated by the FASB [Financial Accounting Standards Board],” the SEC has required compliance with the FASB statements regarding contingent liabilities. For some time, this policy has meant compliance with FASB Statement No. 5. Under this Statement, a “loss contingency” involves an existing condition, situation, or set of circumstances involving uncertainty as to possible loss that will ultimately be resolved when one or more future events occur or fail to occur. When a loss contingency exists, the likelihood that the future event(s) will confirm the loss can range from probable (meaning “likely to occur”) to reasonably possible (“more than remote but less than likely”) to remote (“the chance of the future event or events occurring is slight”). An estimated loss from a loss contingency must be recognized in a financial statement if both of the following conditions are met:

(a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss. (b) The amount of loss can be reasonably estimated.

Alternatively, if one or both of these conditions are not met or if an exposure to loss exists in excess of the amount accrued, the registrant shall disclose the contingency when “there is at least a reasonable possibility that a loss or an additional loss may have been incurred.” The disclosure must describe the nature of the contingency and, if possible, estimate the potential loss. The statement does not require such disclosure where the assertion of a claim is unlikely.

The most troublesome problem under FASB Statement No. 5 involves unasserted legal claims. With respect to unasserted claims and assessments, the statement requires companies to determine the likeli-
hood that suits will be filed.\textsuperscript{110} Should the filing of a lawsuit be deemed "probable," the enterprise must determine the probability of an unfavorable outcome.\textsuperscript{111} If an unfavorable outcome is "reasonably possible," disclosure is required.\textsuperscript{112}

Given the overlap between Regulation S-K Items 101(c)(xii) and 103 and FASB Statement No. 5, the Commission and the judiciary have addressed environmental contingencies under a variety of approaches. For example, in Staff Account Bulletin 92, the staff echoed an FASB Emerging Issues Task Force in stating that "an environmental liability should be evaluated independently from any potential claim for recovery."\textsuperscript{113} Reduction of any loss arising from recognition of an environmental liability by a potential claim for recovery is appropriate only when there is a likelihood that the claim will be realized.\textsuperscript{114} The Bulletin also recognized that an environmental liability for a specific clean-up site may be discounted to reflect the changing value of money over time.\textsuperscript{115} This approach was proper only where "the aggregate amount of the obligation and the amount and timing of the cash payments [were] fixed or reliably determinable for that site."\textsuperscript{116} Finally, the Bulletin suggested that the time value of money also be considered for any asset relating to a claim for recovery of a liability that is recognized on a discounted basis.\textsuperscript{117}

The staff published this Accounting Bulletin to provide guidance to public companies regarding such issues as the methods of presenting contingent liabilities in the balance sheet.\textsuperscript{118} Among other comments, the staff took the position that it is not ordinarily appropriate to re-

\textsuperscript{110} Id.
\textsuperscript{111} Id.
\textsuperscript{112} Id.
\textsuperscript{113} Staff Accounting Bulletin No. 92, 58 Fed. Reg. 32,843, 32,843 (June 14, 1993) (discussing FASB Statement No. 5, the Emerging Issues Task Force and Staff Account Bulletin No. 92)
\textsuperscript{114} Id.
\textsuperscript{115} Id. at 32,844.
\textsuperscript{116} Id.
\textsuperscript{117} Id. at 32,844; cf. Richard Y. Roberts & Kurt R. Hohl, \textit{Environmental Liability Disclosure and Staff Accounting Bulletin No. 92}, 50 Bus. Law. 1 (1994) (concluding that "environmental due diligence" will increase as environmental concerns become more important to the public).
flect in a single net amount a probable contingent liability and an off-
setting claim for recovery. \textsuperscript{119} Similarly, in \textit{Endo v. Albertine}, \textsuperscript{120} the court declined to dismiss a plaintiff’s complaint alleging that a prospectus inadequately disclosed a contingent “superfund” environmental liability. \textsuperscript{121} The court questioned a magistrate’s finding that the combination of the use of the word “Superfund” and a major newspaper article on the topic sufficed to inform a reasonable investor as to the magnitude of the defendant’s environmental liabilities. \textsuperscript{122}

4. Management Discussion and Analysis

In many respects, the most significant mandatory forward-looking statement requirements appear in Item 303 of Regulation S-K. \textsuperscript{123} This Item is of particular significance for “troubled companies” and is a key part of the evolution of the Commission’s approach to accounting from an emphasis on “hard facts” to its emphasis on “soft” or forward-looking information. It is a comprehensive disclosure item. In effect, the Commission staff has employed the concepts of liquidity and capital resources to require managers to comment on material changes that may occur in a registrant’s balance sheet. \textsuperscript{124} The Commission has used the concept of results of operations to require similar disclosures concerning a registrant’s income statement. \textsuperscript{125}

Management discussion of corporate earnings was initially required in 1974, with the Commission obligating registrants to discuss an item of revenue or expense when it changed by more than ten percent in successive periods and changed average net income by more than two percent for the most recent three years presented. \textsuperscript{126} In 1980, after the Sommer Report criticized the numerical materiality test in this

\textsuperscript{119} Staff Accounting Bulletin No. 92, 58 Fed. Reg. 32,843, 32,844 (June 14, 1993).
\textsuperscript{120} 812 F. Supp. 1479 (N.D. Ill. 1993).
\textsuperscript{121} \textit{Id.} at 1487.
\textsuperscript{122} \textit{Id.}
\textsuperscript{125} \textit{Id.}
standard and recommended broadening the analysis to include capital budget plans, the Commission adopted its current approach to the Management Discussion and Analysis Item.

Item 303(a) requires managements of all registrants to discuss and analyze financial condition and results of operations for full fiscal years. Item 303(b) directs registrants required by Article 3 of Regulation S-X to provide a similar analysis in interim financial statements. Management’s discussion and analysis (the “MD&A”) must focus on any facts and uncertainties that may prevent reported financial information from serving as an accurate basis for projecting future operating results or financial condition.

The Commission long has emphasized the need for disclosures concerning liquidity and capital resources. Instruction 5 to Item 303(a) defines liquidity as “the ability of an enterprise to generate adequate amounts of cash to meet the enterprise’s needs for cash.” The registrant is required to “[i]dentify any known trends or any known demands, commitments, events or uncertainties that will result in . . . the registrant’s liquidity increasing or decreasing in any material way.” Similar disclosure must be made concerning commitments for capital expenditures. The registrant must also indicate any expected material changes in the mix and the relative cost of capital resources, as well as consider changes among equity, debt and any off-balance sheet financing arrangements.

A second area of concern involves unusual or infrequent events or transactions or significant economic changes that materially affect revenues or expenses. Examples of significant events that might affect a registrant’s income statement would be the closing of unprofitable manufacturing facilities, changes in inventory, changes in consumer demand or changes in interest rates.

127. Sommer Report, supra note 9, at 365-79.
129. 17 C.F.R. § 229.303(a) (1994).
130. Id. § 229.303(b).
131. Id. § 229.303 instruction 3.
132. Id. § 229.303 instruction 5.
133. Id. § 229.303(a)(1).
134. Id. § 229.303(a)(2).
135. Id. § 229.303(a)(2)(ii).
In 1989, the Commission published a significant interpretative release concerning Item 303.\footnote{137} There the Commission explained the distinction between prospective information that is required to be discussed under Item 303 and voluntary forward-looking statements. It stated that Item 303 requires the disclosure of prospective information based on "currently known trends, events, and uncertainties that are reasonably expected to have material effects," but merely encouraged disclosure of "anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty."\footnote{138} Specifically, the release encouraged registrants, in preparing their MD&A disclosures, to focus on each of the specific categories of known data.\footnote{139} As an example, the Commission cited Item 303(a)(2)(i)’s requirement that the registrant describe its material “commitments” for capital expenditures as of the end of the latest fiscal period.\footnote{140} The release explained that the term “commitments” does not include only those to which the registrant is legally bound.\footnote{141} The Item also mandates disclosure “if material planned capital expenditures result from a known demand, as where the expenditures are necessary to a continuation of the registrant’s current growth trend.”\footnote{142} Similarly, the registrant must disclose any decision not to incur such expenses if it is reasonably likely that the resulting adverse impact on the registrant will be material.\footnote{143} The release further explained:

Where a trend, demand, commitment, event or uncertainty is known, management must make two assessments:

(1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.

(2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant’s financial condition or results of operations is not reasonably likely to occur.\footnote{144}

While this discussion is somewhat less than crystalline in its clarity, the Commission and the judiciary have considerably amplified the forward-looking significance of Item 303 through litigation. Several SEC

\footnote{137}{Management’s Discussion and Analysis, Exchange Act Release No. 26,831, 43 SEC Dock. 1330 (May 18, 1989).}
\footnote{138} {Id. at 1333. The Commission listed the following examples of information that would require disclosure: “A reduction in the registrant’s product prices; erosion in the registrant’s market share; changes in insurance coverage; or the likely non-renewal of a material contract.” Id.}
\footnote{139} {Id.}
\footnote{140} {Id.}
\footnote{141} {Id.}
\footnote{142} {Id.}
\footnote{143} {Id.}
\footnote{144} {Id. at 1333-35.}
proceedings are of note. In *SEC v. Ronson Corp.*,\(^{145}\) a consent order was entered into by a company that failed to describe in its MD&A that its largest customer, which in earlier years had accounted for fifteen percent of consolidated revenues and approximately thirty-three percent of earnings from continuing operations before income taxes, had shut down, suspending all purchases.\(^{146}\)

Similarly, in *Caterpillar, Inc.*,\(^{147}\) the Commission issued a cease and desist order under section 21(c) for Caterpillar's failure to disclose information about its Brazilian subsidiary, CBSA, which was responsible in 1989 for twenty-three percent of Caterpillar's net profits, although its revenues represented only five percent of the parent company's revenues. The Commission explained that Caterpillar "was not required to prepare its consolidated financial statements showing CBSA as either an industry segment or a foreign operation."\(^{148}\) Furthermore, the Commission emphasized that the financial statements and accompanying notes failed to indicate the importance of CBSA's earnings to Caterpillar's overall results of operations.\(^{149}\) This information was required both because (1) the CBSA earnings materially affected Caterpillar's reported income from continuing operations, and (2) there was a future uncertainty regarding CBSA's operations as well as a possible risk of Caterpillar having materially lower earnings as a result of that risk.\(^{150}\)

In *SEC v. Shared Medical System Corp.*,\(^{151}\) the Commission settled a section 21(c) proceeding with an issuer that disclosed a known unfavorable trend in sales activity in a February 17, 1987, press release, but failed to make the same disclosure in its MD&A discussion in its 1986 Form 10-K annual report or its first quarter 1987 Form 10-Q. In *In re Salant Corp.*,\(^{152}\) the Commission settled proceedings when it found that a registrant could not reasonably have concluded that its declining financial condition and cash position would abate in the future. The registrant was required to include in its MD&A discussion of material uncertainties such matters as the fact that, in a prior year, losses incurred had resulted in a fifty-seven percent reduction in credit agreement net worth.\(^{153}\) The Commission concluded that "[b]y failing to discuss its decreasing liquidity, how that decline resulted in uncertainties about its future liquidity, and how [the registrant] Salant in-

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146. *Id.*
148. *Id.* at 63,055.
149. *Id.*
150. *Id.*
153. *Id.*
tended to remedy the problem, Salant failed to comply with the liquidity provision of Item 303.\footnote{154}

As these SEC actions suggest, the Commission has brought enforcement proceedings only in extreme or egregious cases under Item 303. At the same time, the judiciary has clarified that a private litigant cannot bring an implied cause of action based solely on a violation of Item 303.\footnote{155}

5. Tender Offer Rules

Item 4 of Schedule 13D and Item 5 of Schedule 14D-1 require beneficial owners of five percent of specified equity securities and specified tender offer bidders to describe plans or proposals which relate to or would result in specified types of transactions.\footnote{156} Item 4 of Schedule 13D has been a frequent subject of litigation. The courts have refused to grant defendants summary judgment when they made obfuscatory or incomplete disclosures of their purposes and plans.\footnote{157} Courts have issued temporary restraining orders when, for example, a filing person generally disclaimed any plans or proposals "to liquidate the Issuer, sell its assets, merge it with any other person or persons, or make any other major change in its business or corporate structure."\footnote{158} In these cases, the filing person failed to disclose tentative plans to sell the real estate assets of the target while not liquidating its retail assets.\footnote{159}

The typical Item 4 case involves a person who states no present plan to acquire control or merge with a target, but in fact had or subsequently formed that intention. It is a clear violation of Item 4 to make no disclosure of an intent to seek control of or merge with the target when it is proven that this was the acquiror's intent.\footnote{159} To be actiona-
ble, there need not be evidence of a "fixed plan"—merely a purpose (or, as Item 4 states, a proposal) to result in any of the designated actions.\textsuperscript{161} It is sufficient, for example, if a plan or proposal not yet formally approved by the board has been adopted by senior corporate officers, on the assumption that there is sufficient evidence to impute the plan or proposal to the corporation.\textsuperscript{162} A purpose to acquire ultimately a specific percentage of a target's stock would have to be disclosed under Item 4(a).\textsuperscript{163} If a person intends to acquire an unspecified number of additional shares, equivocal or "may acquire" language with respect to additional shares is impermissible.\textsuperscript{164} It is similarly a violation to fail to promptly amend Item 4 of Schedule 13D when a potential acquiror has formed an intent to influence or control a potential target's management.\textsuperscript{165}

While this Item requires disclosure of current plans,\textsuperscript{166} there is no requirement under Item 4 to make predictions of future plans, or to disclose inchoate plans.\textsuperscript{167} Nor need a person disclose plans that are "indefinite, tentative, or still unformed."\textsuperscript{168}

\textsuperscript{161} Chromalloy Am. Corp. v. Sun Chem. Corp., 611 F.2d 240, 246-47 (8th Cir. 1979); K-N Energy, Inc. v. Gulf Interstate Co., 607 F. Supp. 756, 767-68 (D. Colo. 1983). There are also limits to stating too broad a position—such as "we are considering all options"—when plans are more precise. \textit{See K-N Energy,} 607 F. Supp. at 768; \textit{see also SEC v. Amster & Co.,} 762 F. Supp. 604, 613 (S.D.N.Y. 1991) (stating that a decision to seek control requires an Item 4 filing even if no decision has yet been made concerning the means to achieve it).

\textsuperscript{162} \textit{See, e.g.,} Otis Elevator Co. v. United Technologies Corp., 405 F. Supp. 960, 971 (S.D.N.Y. 1975) (stating that a plan will not be considered inchoate if there is strong evidence of its adoption by high corporate officers over a period of time).


On the other hand, the language employed in an Item 4 disclosure is entitled to reasonable inferences. A person who has acquired five percent or more of a potential target and discloses past and ongoing consideration of a tender offer for all or a portion of the unpurchased shares, normally will be granted summary judgment unless the plaintiffs have proof of more definite plans than those disclosed. Only the disclosure of relevant underlying facts, not of any subjective interests, is required.

6. Specific Industries

There also are forward-looking statement requirements for a number of specific industries. For example, Item 102 of Regulation S-K requires disclosure of reserves in the case of extractive industries. This Item will typically require analysis of reserve estimates. Under FASB Statement No. 69, corporations with significant oil and gas producing activities are required to disclose in supplementary information "discounted future net cash flows relating to proved oil and gas reserve quantities." Similarly, Securities Act Industry Guide 4 requires disclosure of the proposed activities of oil and gas programs. Securities Act Industry Guide 7 further requires disclosure of both proved (measured) and probable (indicated) reserves for issuers engaged in significant mining operations.

Bank holding companies are obligated to publish their allowances for loan loss reserves. Property casualty insurance underwriters are

169. See, e.g., S-G Sec., Inc. v. Fuqua Inv. Co., 466 F. Supp. 1114, 1127-28 (D. Mass. 1978) (granting summary judgment where plaintiff has "not shown that defendants had any more definite plans than those disclosed in the Schedule 13D"); see also Vor- nado, Inc. v. Interstate Properties, 470 F. Supp. 714, 717-18 (S.D.N.Y. 1979) (holding that defendant did not have any intentions other than those stated in Schedule 13D); Transcon Lines v. A. G. Becker Inc., 470 F. Supp. 356, 377-78 (S.D.N.Y. 1979) (concluding that plaintiff failed to show that Schedule 13D was misleading with respect to defendants' plans).


172. Id. instructions 3-6; 2 Loss & Seligman, supra note 1, at 647-49.


similarly required to discuss their "significant reserving assumptions."\textsuperscript{177}

Finally, when a partnership rollup transaction occurs, a general partner is obligated, among other things, to compare the value of the proposed transaction to the going concern value of the firm.\textsuperscript{178} This comparison normally will include an appraisal based in part on the future earnings of a partnership.\textsuperscript{179}

\section*{C. Conclusion}

The Commission has gone far to buttress the voluntary forward-looking statement Item 10(b) of Regulation S-K with a number of specific mandatory requirements. Several inferences can be derived from the Commission's approach to forward-looking statements over the past few decades. First, there has never been a high level of compliance with Item 10(b). Claims that recent litigation has had a "chilling effect" on the disclosure of forward-looking statements are overstated. When the Commission believes the disclosure of forward-looking information is necessary to investors, it has had no difficulty mandating its disclosure.\textsuperscript{180} When the Commission has not believed that a mandatory disclosure requirement is warranted, issuers and registrants generally have not voluntarily disclosed forward-looking information.\textsuperscript{181}

Second, it is uncertain that a broader safe harbor would significantly increase voluntary disclosure of forward-looking information. One can argue that market forces could prompt voluntary disclosure of all or most information that is material to investors.\textsuperscript{182} These market forces have proven not to operate particularly well with respect to specific types of forward-looking information such as earnings forecasts.\textsuperscript{183} One can theorize that many firms' disclosure practices, if not subject to mandatory rules, would be the product of both financial considerations and concerns about the firms' competitive position. Because of concerns about the competition's response to dissemination of material financial information, some firms presumably would prefer to suffer lower stock market prices or pay higher costs of capital than to run the risk of inspiring additional or earlier entrants into their product markets (or inspiring takeover bidders). The balance between financial and competitive considerations varies by firm based on such factors as the need for new capital, fear of new competition,

\textsuperscript{178} 17 C.F.R. \$ 229.910 instruction 2 (1994).
\textsuperscript{179} 17 C.F.R. \$ 229.911 (1994).
\textsuperscript{180} See supra part I.B.
\textsuperscript{181} See supra note 76 and accompanying text.
\textsuperscript{182} See 1 Loss & Seligman, \textit{supra} note 1, at 188-92.
\textsuperscript{183} See text accompanying notes 58-60.
and the relative influence of corporate financial and operating executives.

Third, if the Commission seeks to issue a new safe harbor rule or rules, it should do so on a broad canvas. The appropriate safe harbor rule for an earnings forecast may be quite different from the appropriate safe harbor rule for environmental capital expenditures, legal proceedings, contingent liabilities, known material events and uncertainties bearing on future operating results or financial condition, a tender offer bidder’s plans, an extractive industry firm’s probable reserves, a bank holding company’s loan loss allowances, or the going concern value of a partnership engaged in a rollup transaction. Because the facts and circumstances underlying any one of these types of forward-looking statements are variable, I will later urge that the Commission would be wisest to address how litigation can be avoided or reduced through a detailed interpretative release. One point, however, is clear. Any new rule or release should be broad enough to address forward-looking statements under each of the relevant hortatory and mandatory requirements.

II. RISK FACTORS AND ASSUMPTIONS

When the Commission adopted its safe harbor rules for forward-looking statements in 1979, it waffled on the significance of the disclosure of risk factors and assumptions to accompany a forward-looking statement. On one hand, the SEC emphasized the importance of the disclosure of assumptions in aiding investors to understand and to evaluate these statements. On the other hand, the Commission, in accordance with the Sommer Report’s recommendation, declined to mandate disclosure of assumptions in all circumstances. The Commission generally requires the disclosure of risk factors in registration statements and prospectuses, but these requirements do not specifically address forward-looking statements. The thrust of the adoption release was the determination that “[u]nder certain circumstances the disclosure of underlying assumptions may be material to an understanding of the projected results.”

184. See infra part II.B.
186. Id. at 81,942.
187. 17 C.F.R. § 229.503(c) (1994). See generally 2 Loss & Seligman, supra note 1, at 678-82 (discussing the various types of information that could be considered risk factors). There are also specific industry risk factor requirements. See, e.g., 17 C.F.R. § 229.904 (1994) (requiring disclosure of material risks and effects of roll-up transactions).
188. See 17 C.F.R. § 229.503(c) (1994).
189. [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117 at 81,942. The release continued:

The Commission also believes that the key assumptions underlying a forward looking statement are of such significance that their disclosure may be
The Commission has not been clear as to how assumptions and risk factors should be disclosed in the context of various types of forward-looking statements, and has failed to indicate whether disclosure of material assumptions and risks will reduce a firm's expense to liability. This absence of clear guidance has created a lacuna that the judiciary has struggled to address in recent years.

A. The Bespeaks Caution Doctrine

The bespeaks caution doctrine holds that cautionary language accompanying projections may protect against allegations of fraud.\textsuperscript{190} Eight circuits have adopted variants of the bespeaks caution doctrine to limit liability exposure for forward-looking statements.\textsuperscript{191} There is considerable variation in how the courts have developed this doctrine.\textsuperscript{192}

In the First Circuit, the doctrine immunized from liability an alleged omission—"that the standardbred horse industry was entering a recessionary period, making past performance an imperfect indicator of the future"—in light of a detailed attached report describing "a number of specific problems facing the standardbred industry, including overbreeding, declining attendance at races and an average decline in yearling prices."\textsuperscript{193} This application of the bespeaks caution doctrine did not involve a challenge to an express forward-looking statement, but merely a dismissal of an alleged omission.

In the Second Circuit case of \textit{I. Meyer Pincus & Associates v. Oppenheimer & Co.},\textsuperscript{195} plaintiffs alleged that a prospectus was materially necessary in order for such statements to meet the reasonable basis and good faith standards embodied in the rule. Because of the potential importance of assumptions to investor understanding and in order to encourage their disclosure, the rule as adopted indicates specifically that disclosed assumptions also are within its scope.

\textit{Id.}

\textsuperscript{190} Donald C. Langevoort, \textit{Disclosures that "Bespeak Caution"}, 49 Bus. Law. 481, 481 (1994).


\textsuperscript{193} \textit{Romani}, 929 F.2d at 879.

\textsuperscript{194} \textit{Id.}

\textsuperscript{195} 936 F.2d 759 (2d Cir. 1991).
misleading because of two sentences that could be read to suggest that shares of closed-end investment companies were as likely to trade at a premium as at a discount.\textsuperscript{196} The Second Circuit dismissed the complaint based upon a somewhat more detailed discussion elsewhere in the prospectus, which stated that shares of closed-end investment companies frequently trade at a discount from their net asset value.\textsuperscript{197} Neither the First Circuit nor the Second Circuit provided guidance as to how detailed a discussion of a risk factor must be to immunize an allegedly misleading material misrepresentation or omission.

A more detailed analysis appears in the Third Circuit's opinion in \textit{Kaufman v. Trump's Castle Funding (In re Donald J. Trump Casino Sec. Litig.)}.\textsuperscript{198} The \textit{Trump} court stated that, when accompanied by "meaningful cautionary statements," projections may be the basis of a securities fraud claim only if the cautionary language does not affect "the 'total mix' of information" provided.\textsuperscript{199} The court further asserted that the bespeaks caution doctrine applies equally to misrepresentations and omissions.\textsuperscript{200} In either instance, "cautionary statements included in the document may render the challenged predictive statements or opinions immaterial as a matter of law."\textsuperscript{201} Such statements must be substantive and specific; vague or boilerplate disclaimers will not suffice.\textsuperscript{202}

The \textit{Trump} opinion contains two significant limitations on its articulation of the doctrine. First, it is limited to prospective information. In this view, the bespeaks caution doctrine cannot be used to insulate from liability a defendant who misrepresents or omits a historical fact. Second, this case appropriately cautions against invocation of the doctrine when the risk factors or disclosures are vague or boilerplate.\textsuperscript{203} There was little elaboration, however, as to when a disclosure would be vague or boilerplate and, therefore, ineffective.

\textit{Trump} failed to address a third limitation that arguably should apply. A cautionary statement found in a risk factor or disclaimer should be given no weight if the defendants were aware (or should have been aware) of a prospective negative material fact and chose not to disclose it. The bespeaks caution doctrine, in other words, should not be a device by which defendants can obscure or misrepresent prospective bad news.

\textsuperscript{196} \textit{Id.} at 762.
\textsuperscript{197} \textit{Id.} at 761-63.
\textsuperscript{198} 7 F.3d 357 (3d Cir. 1993), \textit{cert. denied}, 114 S. Ct. 1219 (1994).
\textsuperscript{199} \textit{Id.} at 371.
\textsuperscript{200} \textit{Id.}
\textsuperscript{201} \textit{Id.}
\textsuperscript{202} \textit{Id.}
\textsuperscript{203} \textit{Cf.} Pommer v. Medtest Corp., 961 F.2d 620, 624-25 (7th Cir. 1992) (holding that generic warnings do not enlighten investors); Kline v. First W. Gov't Sec., Inc., 24 F.3d 480, 489 (3d Cir. 1994) (declining to apply the bespeaks caution doctrine where plaintiffs failed to show specific reliance on disclaimer).
The Fifth Circuit in *Rubinstein v. Collins*\(^{204}\) has taken a more skeptical view of the bespeaks caution doctrine than the First, Second or Third Circuits. The court stated:

Under our precedent, cautionary language is not necessarily sufficient, in and of itself, to render predictive statements immaterial as a matter of law… The appropriate inquiry is whether, under all the circumstances, the omitted fact or the prediction without a reasonable basis “is one [that] a reasonable investor would consider significant in [making] the decision to invest, such that it alters the total mix of information available about the proposed investment.”\(^{205}\)

The court emphasized that the existence of cautionary language should not be dispositive, and it advocated a case-specific approach.\(^{206}\)

The Sixth Circuit has articulated a different type of skepticism. Modifying an earlier bespeaks caution case, which had held that a claim is insufficient as a matter of law if optimistic opinions are coupled with cautionary statements,\(^{207}\) the Sixth Circuit in *Mayer v. Mylod*\(^{208}\) relied on the Supreme Court decision in *Virginia Bankshares, Inc. v. Sandberg*.\(^{209}\) The Court in *Virginia Bankshares* stated: “But not every mixture with the true will neutralize the deceptive. If it would take a financial analyst to spot the tension between the one and the other, whatever is misleading will remain materially so, and liability should follow.”\(^{210}\) Accordingly, the Sixth Circuit concluded that the true statements must be weighed against the untrue to determine liability.\(^{211}\) The court therefore declined to resolve on a rule 12(b)(6) motion a bank’s statement that the value of loans in its portfolio is “fairly reflected on the balance sheet.”\(^{212}\)

In a relatively brief 1991 decision, the Eighth Circuit applied the bespeaks caution doctrine to economic predictions concerning a residential retirement center.\(^{213}\) The court relied upon a feasibility study attached to an offering memorandum that “contained a number of risk statements, detailed cautionary language and disclosures about the underlying economic assumptions, any of which could have affected the retirement center’s ability to pay back the bonds.”\(^{214}\) The

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\(^{204}\) 20 F.3d 160 (5th Cir. 1994).

\(^{205}\) Id. at 167-68 (alterations in original) (quoting Krim v. BancTexas Group, 989 F.2d 1435, 1445 (5th Cir. 1993)).

\(^{206}\) Id.

\(^{207}\) Sinay v. Lamson & Sessions Co., 948 F.2d 1037, 1040 (6th Cir. 1991).

\(^{208}\) 988 F.2d 635 (6th Cir. 1993).


\(^{210}\) Id. at 1097.

\(^{211}\) 988 F.2d at 639.

\(^{212}\) Id. at 639-40.


\(^{214}\) Id. at 245.
case described neither the economic predictions nor any of the risk statements, cautionary language, or underlying economic assumptions.

The Ninth Circuit generally has followed the Fifth Circuit analysis in *Rubenstein v. Collins*. In *Miller v. Pezzani (In re Worlds of Wonder Sec. Litig.)*, the Ninth Circuit adopted the district court's warning that an unduly expansive application of the doctrine would encourage deliberate misrepresentation by management. The court therefore urged that the doctrine apply "only to precise cautionary language which directly addresses itself to future projections, estimates or forecasts in a prospectus." Blanket warnings of risk should not suffice.

Most recently, the Eleventh Circuit adopted the bespeaks caution doctrine in *Saltzberg v. TM Streling/Austin Assocs.* The brief per curiam decision explicitly applied the doctrine as expressed in *Trump*. The *Saltzberg* court stressed the importance of the context in which the statement is made.

Other circuits have not adopted the bespeaks caution doctrine, but have employed different analytical approaches. The Seventh and District of Columbia Circuits have focused on whether a forward-looking statement had a reasonable basis when made. Presumably a forward-looking statement that ignored negative prospective material information would not have a reasonable basis.

In contrast, the Fourth Circuit has adopted an extreme approach, holding that "projections of future performance not worded as guarantees are generally not actionable under the federal securities laws." Those statements upon which "[n]o reasonable investor

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215. 20 F.3d 160 (5th Cir. 1994); see also Miller v. Pezzani (In re Worlds of Wonder Sec. Litig.), 35 F.3d 1407, 1413 (9th Cir. 1994) (applying the analysis of *Rubinstein*).
216. 35 F.3d 1407 (9th Cir. 1994).
217. Id. at 1414.
218. Id. (quoting *In re Worlds of Wonder Sec. Litig.*, 814 F. Supp. 850, 858 (N.D. Cal. 1993)).
219. Id.
220. 45 F.3d 399 (11th Cir. 1995) (per curiam).
221. Id. at 400.
222. Id.

> In *Malone v. Microdyne Corp.*, 26 F.3d 471, 479-80 (4th Cir. 1994), the Court of Appeals relied on *Raab* in finding that a forward-looking statement was not actionable because the "statement obviously did not constitute a guarantee and was certainly not specific enough to perpetrate a fraud on the market."

would rely" are immaterial, regardless of whether they are accompanied by cautionary language.\textsuperscript{225}

B. Proposed Interpretative Release

The Commission should publish a detailed interpretative release articulating its views as to the appropriate disclosure of risk factors and assumptions to accompany forward-looking statements. Leading judicial decisions to date are neither consistent, detailed, nor particularly useful in addressing forward-looking statements in contexts other than the specific ones that were the immediate subjects of litigation. Nonetheless, certain cases have dismissed complaints alleging material misrepresentations or omissions in forward-looking statements when accompanied by disclosure of risks and assumptions.\textsuperscript{226} These cases suggest that appropriate disclosure of risks and assumptions is a particularly promising approach to the proper insulation of registrants from legal liability with respect to the good faith disclosure of forward-looking statements.

1. Contents of Release

An SEC interpretative release might begin with the Commission's articulation of why forward-looking statements are not guarantees and cannot retrospectively be judged solely on the basis of their inaccuracy. The release could emphasize that the basic criterion of whether a forward-looking statement should be actionable involves whether sufficient information, including risks and assumptions, was disclosed at the time of publication. The appropriate test is whether such information amounts to a material misrepresentation or omission under existing standards of materiality, misrepresentation, omission and culpability established under such antifraud provisions as Securities Act § 11, Securities Exchange Act § 10(b) and rule 10b-5.

The major topic of the release should be a particularization of what the Commission regards as appropriate disclosure of risks and assumptions in each of the categories of required or encouraged forward-looking statements under existing Commission rules and guides. For example, the release might separately address appropriate risks and assumptions disclosure for earnings forecasts, environmental compliance costs, and extractive industry reserves, among other areas. In each instance different modes of analysis may be appropriate. Indeed, discussion of earnings forecasts (as well as other forward-looking statements) may invite different Commission discussion depending on the industry involved.

The release also would offer the Commission the opportunity to state that an issuer or registrant can be held liable only for its own

\textsuperscript{225} Id. at 211.
\textsuperscript{226} See supra notes 193-221 and accompanying text.
forward-looking statements—not those of financial analysts or other third parties—unless the issuer or registrant's level of entanglement with the outsider satisfies a relevant culpability standard.227

227. See, e.g., Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937, 949 (2d Cir. 1969) (holding that item in Wall Street Journal column “Heard on the Street” was not attributable to the issuer: “While a company may choose to correct a misstatement in the press not attributable to it, . . . we find nothing in the securities legislation requiring it to do so.”); see also Ososky v. J. Ray McDermott & Co., 725 F.2d 1057, 1059 (2d Cir. 1984) (holding that defendant had no obligation to correct statement on the Dow Jones broad tape); State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 850 (2d Cir. 1981) (“A company has no duty to correct or verify rumors in the marketplace unless these rumors can be attributed to the company.”).

In Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980), the Second Circuit observed:

We have no doubt that a company may so involve itself in the preparation of reports and projections by outsiders as to assume a duty to correct material errors in those projections. This may occur when officials of the company have, by their activity, made an implied representation that the information they have reviewed is true or at least in accordance with the company’s views. Id. at 163. But a company assumed no duty to disclose its own internal earnings forecasts or to warn analysts that their optimistic view was not shared by the company if it merely reviewed analyst reports and made suggestions as to factual and descriptive matters while adhering to a policy not to comment on earnings forecasts. Id. The courts similarly have been unwilling to enforce a rule requiring companies to read every article written about them and to correct inaccuracies in them. See, e.g., Hershfang v. Citicorp, 767 F. Supp. 1251, 1255-57 (S.D.N.Y. 1991) (holding that Citicorp was not responsible for newspapers’ inaccuracies or for executives’ opinions on future earnings); Schwartz v. Novo Industri, A/S, 658 F. Supp. 795, 799 (S.D.N.Y. 1987) (holding that predictive statements made to newspaper did not give rise to liability); In re Commonwealth Oil/Tesoro Petroleum Corp. Sec. Litig., 467 F. Supp. 227, 240 (W.D. Tex. 1979) (holding that executives do not have to correct others’ misstatements about acquisition target); Milberg v. Western Pac. R.R., 51 F.R.D. 280, 282 (S.D.N.Y. 1970) (dismissing motion to certify class based on inaccurate predictions of a financial publication), dismissed on other grounds sub nom. Korn v. Franchard Corp., 443 F.2d 1301 (2d Cir. 1971). On the other hand, a company can be held liable for a statement in a newspaper article that repeats misstatements in a document filed with the Commission. See, e.g., Blakely v. Lisac, 357 F. Supp. 255, 263 (D. Or. 1972) (treating article repeating statements from Interim Report as if it were calculated to influence); cf. SEC v. Century Inv. Transfer Corp., [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,232, at 91,443 (S.D.N.Y. 1971) (stating that publicizing a merger and not publicizing its subsequent abandonment may be misleading); SEC v. Electrogen Indus., [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶92,156, at 96,716-19 (E.D.N.Y. 1968) (stating that distributing brochures that contain misrepresentations may actively mislead investors). Similarly, an issuer can be held liable for an inaccurate earnings projection made by its underwriter and marketer and publicly discussed in the presence of its officers. Green v. Jonhop, Inc., 358 F. Supp. 413, 419-420 (D. Or. 1973); cf. In re Time Warner Inc. Sec. Litig., 794 F. Supp. 1252 (S.D.N.Y. 1992), aff’d, 9 F.3d 259 (2d Cir. 1993):

Only statements attributable to the defendants, or omissions by them, can support the claims against them. . . . [N]either the alleged statements by anonymous Time Warner sources which are quoted in the complaint nor analysts’ and journalists’ reports allegedly based on information gleaned from Time Warner sources may be attributed to the defendants.
The Commission also could address an issuer's duty to correct a forward-looking statement. Rule 10b-5 requires the issuer "to state [any] material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."\textsuperscript{228} The Commission frequently has identified a duty to correct statements made in any filing that "either have 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."\textsuperscript{229}

Similarly, the cases have recognized that a company's failure to correct the misleading impression left by statements already made constitutes a fraud.\textsuperscript{230} This duty has been held to exist as long as prior
statements remain “alive.” The courts have not been particularly precise as to how long that period will be.

Under rule 13d-2(a), an amendment must be filed “promptly” to disclose any material changes that occur in a Schedule 13D filing. The appropriate time frame may vary from case to case. Factors such as the degree of deviation and the amount of time elapsed between the making of the statement and the occurrence of the subsequent event may affect whether a statement has become materially misleading.

The Commission also should offer commentary concerning the lifespan of a forward-looking statement and accompanying risks and assumptions disclosure, how promptly statements need to be corrected and the mechanics of how corrective disclosure should be made. The Commission should restrict its discussion concerning forward-looking statements and accompanying risks and assumptions to written statements. If a basic purpose of publishing an interpretative release is to facilitate judicial dismissal of nonmeritorious suits (or to


232. In Ross v. A. H. Robins, Co., the court explained:

Both section 10(b) and Rule 10b-5 are silent as to the effect of time on the duty to correct, but logic compels the conclusion that time may render statements immaterial and end any duty to correct or revise them. In measuring the effect of time in a particular instance, the type of later information and the importance of earlier information contained in a prior statement must be considered. Thus, general financial information in a two-year-old annual report may be stale and immaterial. However, no general rule of time can be applied to all circumstances. Rather, a “particular duty to correct a specific prior statement exists as long as traders in the market could reasonably rely on the statement.” 465 F. Supp. at 908 (citations omitted).

In Ross, the court concluded that the 1970 statements of a pharmaceutical manufacturer concerning clinical data about one of its products would still be actionable in 1974 when “[t]he mere passage of time would not alone deter the trader in the market from relying on these statements.” Id. Accord Kamerman v. Steinberg, 123 F.R.D. 66 (S.D.N.Y. 1988) (holding that voluntary public statements must be corrected if failure to do so would be misleading).

233. Cf. In re Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1246 (3d Cir. 1989) (“[T]he question of whether an amendment is sufficiently prompt must be determined in each case based upon the particular facts and circumstances surrounding both prior disclosures by the acquirer and the material changes which trigger the obligation to amend.”).


235. For example, does the initial preparation of an internal earnings estimate or construction costs estimate mandate disclosure or can a corporation wait until a review process is completed? Cf. Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 516 (7th Cir. 1989) (holding that tentative statements of nuclear reactor costs need not be disclosed unless the figures are so definite as to make the published estimate misleading).
deter their filing), this goal may be difficult to achieve with oral statements (where there are often fact controversies as to what was said). The courts have evolved a doctrine sometimes called "justifiable reliance," under which they generally have precluded a plaintiff from relying on an oral statement in contradiction to a written statement. This approach seems particularly apposite to forward-looking statements both because written statements are better evidence than memories of oral statements and because of the improbability that an appropriately detailed discussion of risks and assumptions will be communicated orally.

2. Advantages of Release

A detailed Commission release addressing risks and assumptions disclosure offers several advantages. First, issuers and registrants would maintain control over how detailed their disclosure of risks and assumptions would be. Issuers would have the ability to opt in or out of different types of disclosure based on their evaluation of business competition and other factors that bear on voluntary disclosure decisions.

Second, the approach could provide detailed interpretative guidance to issuers with respect to each type of mandatory and hortatory forward-looking statement identified in Commission rules and guides. The advice might be accompanied by illustrations of what the Commission considers appropriate risks and assumptions disclosure in specific circumstances. The use of illustrations is a technique often used

236. See, e.g., Kennedy v. Josephthal & Co., Inc., 814 F.2d 798, 804 (1st Cir. 1987) (citing factors used by courts in examining whether reliance on misrepresentations is justified); see also Atari Corp. v. Ernst & Whinney, 981 F.2d 1025, 1030 (9th Cir. 1992) (finding merger participants' continued reliance on patently inaccurate financial information to be unjustified); Davidson v. Wilson, 973 F.2d 1391, 1400-01 (8th Cir. 1992) (finding that sophisticated investors with access to relevant information and opportunity to discover fraud did not reasonably rely on misstatements); Myers v. Finkle, 950 F.2d 165, 167 (4th Cir. 1991) (charging investors with constructive knowledge of risks and warnings contained in private placement memoranda); Bruschi v. Brown, 876 F.2d 1526, 1529-30 (11th Cir. 1989) (finding that longstanding financial advisor defrauded unsophisticated client using alleged oral misrepresentations); Jackvony v. RIHT Fin. Corp., 873 F.2d 411, 416-17 (1st Cir. 1989) (rejecting investors' right to rely on oral statements that were specifically excluded from subsequent written agreement); Grubb v. FDIC, 868 F.2d, 1151, 1164 (10th Cir. 1989) (finding that a sophisticated investor could claim fraud when there was little access to information, little opportunity to discover fraud and other party made specific misrepresentations); Wilco Kuwait (Trading) S.A.K. v. deSavary, 843 F.2d 618, 623 (1st Cir. 1988) (discussing whether misrepresentations about a company's poor financial condition were made and whether plaintiff could justifiably rely on these misrepresentations); One-O-One Enters. v. Caruso, 848 F.2d 1283, 1286-87 (D.C. Cir. 1988) (holding that an integration clause in the final agreement precluded a claim of reasonable reliance on oral statements).

237. Cf. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 743 (1975) (criticizing "hazy issues of historical fact the proof of which depended almost entirely on oral testimony").
by the Financial Accounting Standards Board when it interprets accounting standards. This technique would allow the Commission to offer illustrative advice on a common form of statement without rigidly binding the agency with respect to its analysis of other types of risks and assumptions.

Third, a key advantage of an interpretative release is that it could shift the focus of the analysis of the appropriateness of forward-looking statements, risks, and assumptions from court proceedings to the Commission. The SEC long has displayed considerable ability in helping issuers and registrants avoid litigation through such extrajudicial techniques as no-action or interpretative letters. This type of correspondence could usefully be employed to provide issuers and registrants an ongoing gauge of the staff’s views on evolving disclosure issues concerning forward-looking statements.

C. The Inadequacy of Other Approaches

1. Safe Harbor Rules

Compared to an interpretative release, any safe harbor for forward-looking statements will provide limited guidance as to how an issuer or registrant can appropriately disclose the risks and assumptions underlying a forward-looking statement. A detailed interpretative release would reduce the need for further insulation of issuers and registrants from civil liability for forward-looking statements. The Commission does not write on a clear slate in this area. Quite aside from the adoption by eight circuits of the “bespeaks caution” doctrine, the Supreme Court has issued several opinions that have narrowed the contours of civil rule 10b-5 liability. Notably, the Court has held:

(1) Private standing under section 10(b) and rule 10b-5 is limited to actual purchasers or sellers.

(2) A private claim for damages under section 10(b) and rule 10b-5 may not lie in the absence of an allegation of intent to deceive, manipulate, or defraud on the part of the defendant. An allegation of negligence is insufficient to support such a claim. The Court reserved and continues to reserve the question of whether recklessness will suffice.

238. See, e.g., FASB Working on Illustrations for Statement 119, Lucas Says, 26 Sec. Reg. & L. Rep. (BNA) No. 45, at 1556 (Nov. 18, 1994) (reporting that the FASB is researching examples to clarify its disclosure standard for derivative instruments).

239. See 1 Loss & Seligman, supra note 1, at 525 n.29.

240. See supra text accompanying notes 91-127.

241. See supra text accompanying notes 191-222.


244. See id. at 199-211.

245. See id. at 194 n.12.
(3) A breach of fiduciary duty alone will not violate section 10(b) and rule 10b-5. There must be proof of fraud.\textsuperscript{246}

(4) In 1991 the Supreme Court adopted a one-year-after-discovery rule and a three-years-after-violation statute of limitations for rule 10b-5 litigation that in most cases shortened the earlier applicable limitations period.\textsuperscript{247}

(5) In 1994, the Court held that a private plaintiff could not maintain an aiding and abetting suit under section 10(b).\textsuperscript{248}

In addition, a substantial percentage of federal securities class actions recently have been dismissed on a pretrial motion.\textsuperscript{249}

The cumulative effect of these Supreme Court and lower federal court decisions should discourage the filing of nonmeritorious civil federal securities claims. There are broader concerns at stake, however, in evaluating the wisdom of encouraging or discouraging civil federal securities litigation. Such litigation provides a means of private enforcement of the federal securities laws' mandatory disclosure system. This system is usually defended in terms of deterring fraud, reducing excessive insider or financial intermediary compensation, and increasing public confidence in the securities market. A further justification advanced is that of necessity, given the historical performance of voluntary, state law, and securities market disclosure regimes.\textsuperscript{250} The information provided by the SEC's disclosure system can be likened to a public good that would be underprovided, because of its nonexcludability, but for the securities laws' mandatory requirements.\textsuperscript{251} A practical consequence of addressing the market failure implicit in the nonexcludability of information is a general improvement in the allocative efficiency of investment.\textsuperscript{252}

The mandatory disclosure system also may have attributed to higher levels of aggregate investment in United States securities. According to the New York Stock Exchange, over fifty-one million United States citizens directly owned corporate stock in 1990.\textsuperscript{253} This figure represented approximately 21.1\% of the total population in 1990,\textsuperscript{254} and was over thirty times greater than the 1.5 million persons


\textsuperscript{250} 1 Loss & Seligman, supra note 1, at 193.


\textsuperscript{252} Id. at 734-37.


(equal to 1.2% of the population)\textsuperscript{255} who owned stock in 1929, on the eve of federal securities regulation.\textsuperscript{256}

Given the limited Commission resources available for the enforcement of its mandatory disclosure system, private litigation has been recognized as performing a useful augmentative deterrent,\textsuperscript{257} as well as compensatory,\textsuperscript{258} role. If the mandatory disclosure system is worth preserving, the Commission should seek to ensure that reductions in the effectiveness of private federal securities litigation do not produce a corresponding weakening of the disclosure system. This weakness is potentially the most serious consequence of restrictions in the private enforcement of the federal securities laws.\textsuperscript{259}

Finally, the Commission's authority to adopt safe harbor provisions to insulate issuers and registrants from civil liability for forward-looking statements is a limited one. Rule 175 of the Securities Act of 1933 and rule 3\textsuperscript{b}-6 of the Securities Exchange Act of 1934 are definitional rules, adopted under section 19(a) of the 1933 Act and sections 3(b) and 23(a)(1) of the 1934 Act, specifying when forward-looking statements shall not be deemed fraudulent. Unlike other safe harbor provisions, which do not purport to exempt transactions from civil liability, but only from registration requirements,\textsuperscript{260} the forward-looking statement safe harbor rules do not acknowledge any restrictions in their scope, either in the text of the rules or the adoption release.\textsuperscript{261}

Nonetheless, the structure of the federal securities laws places some limits on the rulemaking authority of the Commission. Section 19(a) of the 1933 Act, for example, restricts the Commission's rulemaking authority to that "necessary to carry out the provisions of this title." Sections 3(b) and 23(a)(1) of the 1934 Act contain similar formulae.\textsuperscript{262}

In one recent decision, the District of Columbia Court of Appeals struck down former rule 19c-4 when it viewed that Rule as exceeding

\textsuperscript{256} S. Rep. No. 1455, 73d Cong., 2d Sess. 9 (1934).
\textsuperscript{258} 10 Loss & Seligman, supra note 1, at 4578-80.
\textsuperscript{259} For further discussion of the debate concerning the need for further restrictions on federal securities class actions, see Grundfest, supra note 249; Joel Seligman, The Merits Still Matter: A Rejoinder to Professor Grundfest's Comment, Why Disimply?, 108 Harv. L. Rev. 748 (1995); Seligman, supra note 249.

Section 23(a)(1) appears to be somewhat broader when it refers to the adoption of rules "necessary or appropriate to implement the provisions of this chapter." Id. § 78w(a)(1).
the Commission's authority to adopt an initiative "in furtherance of the purposes of [the Exchange Act]." 263

Rule 3b-6 seemingly conflicts with the materiality and culpability standards that the Supreme Court applies when interpreting antifraud provisions such as rule 10b-5 or 14a-9. Where, for example, the Supreme Court has defined materiality to embrace "statements of reasons, opinions, or belief" under rule 14a-9, 264 rule 3b-6 only applies to certain filings with the Commission. Rule 3b-6 does not appear to preclude other types of forward-looking statements from being held actionable.

More significantly, while the Supreme Court in Ernst & Ernst v. Hochfelder 265 held that section 10(b) and rule 10b-5 require an allegation of scienter and specifically rejected negligence as an adequate pleading of culpability, 266 rule 3b-6 appears to embrace precisely such a negligence standard when it requires a plaintiff to prove that a forward-looking statement "was made or reaffirmed without a reasonable basis." 267 In Ernst & Ernst, the Supreme Court emphasized that the Commission's rulemaking authority under section 10(b) could not be extended to activities that do not involve scienter. 268 As a result of this holding, the Commission lacks the authority, under general rulemaking provisions, to change the culpability provision of a specific section such as § 10(b). Hence, it should hardly be a surprise to the Commission 269 that the lower federal courts often have declined to rely on rule 3b-6 when that rule has been implicated in rule 10b-5 litigation. 270

A few proposals currently before the Commission attempt to change the elements of rule 10b-5 liability through safe harbor proposals. 271 I am skeptical that either existing rule 3b-6 or these propos-

266. Id. at 212-14.
267. 17 C.F.R. § 240.3b-6 (1994).
268. See Ernst & Ernst, 425 U.S. at 212-14. Pointedly, the Supreme Court added: "The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law." Id. at 213.
270. The Seventh Circuit's reliance on rule 175 in Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 513-16 (7th Cir. 1989), a § 11 case, presents a closer question of applicability since the term "reasonable basis" in rule 175 may be viewed as a synonym for such terms as "reasonable investigation" in § 11 of the 1933 Act.
als can, under existing precedent, administratively alter the elements of a rule 10b-5 claim. The Commission does appear, however, to possess the authority to adopt rule 3b-6 as a safe harbor from the initiation of a Commission proceeding for those firms that comply with the conditions of that rule.

2. Disimplication

Other proposals before the Commission would disimply private causes of action for forward-looking statements in specified circumstances. Given the Supreme Court's discussion of the Commission's rulemaking authority in *Ernst & Ernst v. Hochfelder* and court decisions implying a private cause of action under rule 10b-5, I am skeptical that the Commission could retain such rules as 10b-5, but partially disimply from that rule civil liability for forward-looking statements. The Commission could disimply civil liability under rule 10b-5 if it were willing to totally rescind the rule. The Commission could then reenact the substance of rule 10b-5 under another section of the federal securities acts that does not imply private causes of actions. Disimplication could, therefore, be achieved by mechanical means.

Nonetheless, it would be unwise for the Commission to pursue such an approach. Disimplication would have a greater capacity to preclude private federal securities litigation than would a broader safe harbor for forward-looking statements. Given the uncertainty as to a need for further changes in the contours of private federal securities litigation, disimplication would appear unwise at this juncture. Even the leading proponent of disimplication has acknowledged: "At the end of the day, and despite recent congressional hearings, we simply do not know enough about the securities litigation process to propound categorical reforms with any degree of confidence that we would be doing more good than harm." To preserve the integrity of the Commission's mandatory disclosure system, it would be wiser

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*cf. Basic, Inc. v. Levinson, 485 U.S. 224, 245 (1988) (permitting reliance to be presumed in specific circumstances).*


273. The most thoughtful analysis of this approach appears in Grundfest, *supra* note 272, at 1011-15.


275. See, *e.g.*, Superintendent of Ins. v. Bankers Life & Casualty, 404 U.S. 6, 13 n.9 (1971) ("It is now established that a private right of action is implied under § 10(b).").

for the agency to proceed with the precision and detail that an interpretative release approach can offer. The ultimate risk of disimplication is that it will prevent meritorious as well as nonmeritorious private litigation from going forward. This situation could result in the underdeterrence of securities fraud. Underdeterrence is particularly a risk with respect to overly optimistic forward-looking statements.

**Conclusion**

The Securities Act of 1933, in part, was adopted because of the prevalence of unsubstantiated forward-looking statements.\(^{277}\) Recent Commission experience in such areas of exemption as municipal securities suggests that the capacity of issuers and registrants to issue securities without adequate disclosure has not vanished.\(^{278}\) The Commission would be wise to proceed with measured incremental steps in areas where the risk of fraud is real.

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