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Soft Information: The SEC's Former Exogenous Zone

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INTRODUCTION

Few regularly recurring problems are more agonizing to corporate managers and their legal advisors than those involving securities law disclosure requirements. The so-called materiality standard for screening out what must be disclosed is of little aid. Material information can be described accurately only as a tautology: the SEC's and the courts' views from time to time of what they believe investors believe is important.¹

The murkiness of the materiality standard is surpassed only by the practical problems of monitoring the mass of unarticulated data available for most businesses to determine which items of information are candidates for inclusion under the materiality concept. Moreover, it is nearly impossible for a manager constantly to keep disclosure obligations at the forefront of his mind, given the equally pressing demands to comply with a great volume of government regulations with respect to safety, employment relations, taxes, retirement benefits, anti-trust, consumer

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1. See SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 10 (2d Cir. 1977). [S]ince the importance of a particular piece of information depends on the context in which it is given, materiality has become one of the most unpredictable and elusive concepts of the federal securities laws. The SEC itself has despaired of providing written guidelines to advise wary corporate management of the distinctions between material and non-material information, and instead has chosen to rely on an after-the-fact, case-by-case approach, seeking injunctive relief when it believes that the appropriate boundaries have been breached. Id. at 10; cf. Hewitt, Developing Concepts of Materiality and Disclosure, 32 Bus. Law. 887, 892 (1977) (materiality suffers from problems of definition and attempts to define the term are generally circular).
protection, and other areas, to say nothing of his manufacturing, marketing, and financing responsibilities.

That courts are quite willing to second-guess disclosure decisions after a plaintiff's attorney artificially focuses the spotlight of attention on the particular failure of disclosure serves to increase the pain. Managers cannot sleep nights knowing that once a datum has been so isolated, plaintiffs, their lawyers, and some courts and juries will confuse relevance and materiality; that is, they tend to consider as appropriate for disclosure any datum which might be relevant to some investor, no matter how relatively insignificant it may be in the overall picture.2

Securities lawyers, appreciative of all this, have sought to develop particularized rules and procedures to lessen the uncertainty of disclosure requirements and to formulate feasible disclosure practices. This task now has been dramatically enlarged with a vast new area for concern: it recently has been recognized officially that "soft information," as well as "hard," can be of great importance to investors.3 Indeed, investment analysts consider

2. The problem is not removed by the Supreme Court's decision in TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976). The Court stated that only data which "would" be important to a reasonable investor is material. Id. at 445-49. The "would" test is highly pliable and difficult to oversee. The Court also adopted the "buried facts" doctrine, to the effect that disclosure is inadequate when a material datum is buried in a mass of data. Id. at 448-49. The courts seem unable to perceive that a corollary to the buried facts doctrine is that once an undisclosed fact is culled out by a plaintiff's lawyer and placed in prominence, it acquires an undue aura of importance. The courts instead should see that when managers view a mass of data when considering disclosure, the particular datum at issue may be so buried as not to command sufficient attention to indicate the need to disclose. See also Hewitt, supra note 1, at 892.

3. See generally House Comm. on Interstate and Foreign Commerce, 95th Cong., 1st Sess., Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission 344-79 (Comm. Print 1977) [hereinafter cited as Report], abstracted in [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,357. Soft information includes forecasts of earnings, revenues, and other financial data; budgets for capital expenditures; future dividend policy; management analyses of financial statements; or any other forward-looking or even past, but subjectively determined, information concerning prospects of a company for investment use. In contrast, historical and objectively verifiable information is sometimes termed "hard information." Id. at 347. See also Kohn v. American Metal Climax, Inc., 458 F.2d 255, 265 (3d Cir.), cert. denied, 409 U.S. 874 (1972) (soft information includes "future earnings, appraised asset valuations and other hypothetical data"). In fact there is no clear delineation between hard and soft data. It has been said that, "[m]any apparently hard statements have soft cores and vice versa." Schneider, Nits, Grits, and Soft Information in SEC Filings, 121 U. Pa. L. Rev. 254, 256 (1972). Schneider offered an explanation of the term:

Although a comprehensive definition of soft information is not readily apparent, several non-exclusive and non-exhaustive categories can be identified: (1) forward-looking statements concerning the future, such as projections, forecasts, predictions, and statements concerning plans and expectations; (2) statements concerning past or present situations when the maker of the statement lacks the data necessary to prove its
projections, one type of soft data, to be at the heart of the body of information important for their tasks.\(^4\) Other soft data such as the firm’s estimated market share are also important to investors, as are capital budgets and the like.

Traditionally, SEC practices and procedures had prohibited the publication of most soft information in SEC-filed documents, although informal dissemination in press releases and other publications exogenous to SEC filings always has been common.\(^5\) The basic concerns of the SEC have been that allowing soft information in filed documents could diminish the reputation of SEC documents as strictly “factual” and increase the potential for deception of investors who, it is feared, might place undue credence in such data.\(^6\) However, recent years have seen the removal of restrictions on some soft information and the inclusion of other soft data in the mandatory disclosure scheme. For example, projections of earnings and revenues and certain appraisal information are permitted, while management analyses of summaries of financial data are required in registration statements and some other filings.\(^7\)

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\(^{5}\) See note 75 & accompanying text infra.

\(^{6}\) It has been the Commission’s long-standing policy not to permit projections and predictions in prospectuses and reports filed with the Commission. Such documents are designed to elicit material facts. Their factual character is widely recognized. Investors and their advisors are at liberty to make their own projections based on the disclosures resulting from the Commission’s requirements. A real danger exists, in the Study’s judgment, that projections appearing in prospectuses and other documents filed under the securities laws and reviewed by the Commission would be accorded a greater measure of validity by the unsophisticated than they would deserve.

The SEC Advisory Committee on Corporate Disclosure in its Report\(^8\) applauds this recent change of policy, recommends further experimentation, and proposes a “safe harbor” rule to encourage companies to make disclosures of soft information. The Committee has singled out certain categories of soft data as meriting special attention by the Commission, including permissive disclosure of management’s forecasts of sales and earnings, capital expenditures budgets, plans and objectives, dividend policy, and capital structure policies as well as alteration of the already mandatory management analysis of financial statements.\(^9\) Since publication of the Report, the SEC has instructed its staff to consider modes of implementing the Advisory Committee’s recommendations on soft information.\(^10\)


9. See notes 26-61 & accompanying text infra.
Interestingly, despite dissents from members of the Advisory Committee on other aspects of the Report, there is virtual unanimity on the recommendations concerning soft information. Perhaps this is due in part to the fact that most of the soft information disclosure recommendations call for voluntary, permissive disclosure while much of the disagreement in the Committee centered on the expressed conclusion that a mandatory system is appropriate for hard (as well as some soft) disclosures, as at present.\(^1\)

This Article sets forth: (a) the conventional wisdom, right or wrong, concerning why soft information is considered relevant to investment decision making, (b) a description in greater detail of the recommendations of the Advisory Committee, which are based on this conventional wisdom, and (c) a discussion of some special problems of liability for misrepresentation which will have a bearing on issuers' decisions whether voluntarily to disclose more soft data, a course which the Advisory Committee urges the SEC to encourage issuers to follow.

I. THE CONVENTIONAL INVESTMENT DECISION PROCESS

Rational investors selecting from among securities, whether corporate stocks or bonds, real estate, commodity options, savings accounts or any of a myriad of others,\(^2\) calculate how their wealth may be maximized by selection among the alternatives available. Traditionally, the basic investment technique has been to determine an amount to be invested and then to purchase the security expected to yield the highest return\(^3\) for the desired degree of risk.\(^4\)

The process can be analyzed with slightly more refinement. It may be said that the investor's purpose is to maximize his wealth, which can be calculated by determining the present value of the stream of expected future income.\(^5\) Thus, if an individual

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\(^1\) See notes 27-30 & accompanying text infra.

\(^2\) In the terminology of economists, a "security" is defined far more broadly than under the securities laws, including any income-earning asset whether commonly known as a security or real estate or something else. See W. Sharpe, Portfolio Theory and Capital Markets 19 (1970) (defining security as a "decision affecting the future").

\(^3\) There has been a running dispute as to whether "return" means enterprise earnings or the dividends and gain or loss on resale by the investor. See V. Brudney & M. Chirelstein, Corporate Finance 419-46 (1972). These two are actually equivalents when properly adjusted, basically because earnings of the enterprise ultimately result in dividends or are reflected in resale prices of the securities. See Miller & Modigliani, Dividend Policy, Growth, and the Valuation of Shares, 34 J. Bus. 411 (1961).

\(^4\) Risk is defined as the chance that the actual return on an investment is likely to diverge from the expected return. W. Sharpe, supra note 12, at 25-26.

\(^5\) See note 18 & accompanying text infra (calculation of present value).
is convinced that there is no value to the future income, as he will be if the world is to end tomorrow, most likely he will consume today whatever he can to the extent he pleases. Under less unusual conditions, the near future is more likely to be attained and the investor has a choice between consumption now and probable consumption later. In this situation, he may be able to increase his total wealth by wise investment.

What does it mean, to increase wealth, and how does one make wise decisions on how to invest?

A. The Traditional Model of Investment Decision Making

The traditional technique of investment decision making is cogently explained by Professor William Sharpe. As Sharpe suggests, the initial investment choice is between consumption now and consumption at a later time. The psychological fact that most people are willing to sacrifice a greater amount of future consumption for a lesser amount of present consumption explains their willingness to pay interest for borrowings. Similarly, because the lender prefers present consumption, he demands interest on loans.

If an investor has $100 at the beginning of this year, he might consume it all now, save it all for later, or consume some now and some later. That which he does not consume may be invested and earn interest. If the investment is riskless, the amount paid by the investee is merely the negotiated amount that he is willing to pay for the present enjoyment and which the investor is willing to accept for deferral of enjoyment. This is often referred to as the "pure" interest rate.

On the assumptions that the investor could borrow at the pure interest rate and that he will receive that rate for any deferred receipts, the pattern of receipts is irrelevant. The cash, if received at the beginning, may be banked at the pure rate. If the $100 plus interest is received at any later time, even in installments, the investor may borrow at the pure rate for earlier consumption. Thus, at the outset he could have $100 cash immediately available for consumption. Conversely, in the second year, he instead could have $107 available for consumption. In any case, his wealth is the same—$100 at present value.

Sharpe uses a simple graph to illustrate his points. In Figure 1 below, note that present and future consumption may be determined at any point along the x-w line if our subject's present wealth is $100 and if the interest rate is seven percent:

16. Cf. Isaiah 22:13 ("Let us eat and drink; for tomorrow we shall die").
17. W. SHARPE, supra note 12, at 7-17.
If the individual consumes the entire $100 this year, he will have nothing for next year, and his two-year pattern of consumption will be plotted at point \( w \). If he consumes nothing this year, he may consume $107 next (point \( x \)). Similarly, he may choose any point along the \( x-w \) line, for example, $60 this year and $42.80 next (point \( z \)).

Further, if the individual finds an investment that returns more than the pure interest rate, he may increase his overall wealth and consumption. Thus, if he is able to invest $20 this year in return for an investment cash flow of $32.10 next year, he could consume $40 this year and $42.80 plus $32.10, or $74.90 next (point \( z \)), a present value (discounted at seven percent) of $110—an increase of $10 in present value of wealth.\(^{18}\) By also

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\(^{18}\) Or he could consume $60 this year, invest the $20 in the highly profitable security to receive $32.10 and get seven percent on the remaining $20 of the $100. He will then be able to consume $53.50 next year. The present value, discounted at seven percent will still be $110, composed of the $60 consumed, the $32.10 discounted at seven percent (to $30) and the $20 invested at seven percent. This description of the latter two amounts also explains the concept of present value: the $20, to be invested at seven percent, manifestly has a value at present of $20 if we assume seven percent as the standard of price to be paid for deferral of enjoyment. Applying the same standard of seven percent, we can determine that $32.10 received next year is equivalent to $30 invested at seven percent. Thus although the cost of that investment is $20, its
borrowing or lending in year one (at seven percent), he may con-
sume at any point along the \( a-b \) line. Hence, it is desirable that
one invest at a higher rate of return than the pure interest rate. By
the same reasoning, if the return on the putative investment would
be less than seven percent, his total two-year satisfaction will be
greater if he consumes in year one or saves at the seven percent
rate instead of investing at the lesser rate.

The next question, how to choose among alternative invest-
ments, would be no problem if no risk were involved: all would
choose the investment paying the highest rate of return.\(^{19}\) Of
course, other factors being equal, if there is no risk, no investee
would have to pay more than the pure interest rate. There is risk,
however, and the return on risky investments therefore must ex-
ceed the pure interest rate to be attractive.\(^{20}\) We see, then, that
return may be thought of as consisting of two elements—the pure
interest rate, as for a riskless loan, and the additional return for
carrying the particular risk.\(^{21}\) Hence, the problem of selecting
among securities basically has been reduced to weighing the re-
turns against the risks and comparing results among different se-
curities.

B. Relevance of the Traditional Investment Decision Model to
Securities Law

It is clear why an investor is interested in data concerning risk
and return. If he can determine his probable return on an invest-
ment and the risk that his actual return will vary from this proba-
ble return, then he will be able to determine what portion of his
income he should invest in particular securities, thereby maximiz-
ing his wealth at the desired risk level. The analysis of risk and

\(^{19}\) Value, assuming a seven percent discount rate for measuring values, is $30. See also A.
Alchian & W. Allen, University Economics 201-09 (2d ed. 1967).

\(^{20}\) This is not entirely accurate. Some investments may be more or less attrac-
tive depending on such factors as "snob appeal." Thus, Rolls Royce shares were attrac-
tive to some investors even when the company appeared bankrupt, and some of
the attraction was probably due to factors other than risk and return. Also, in this era
of social consciousness, at least a few investors may be motivated otherwise than by
profitability, at least in part. Moreover, often members of the family of the founder of
a company will prefer that company's securities, often without regard to risk or re-
turn.

\(^{21}\) Return, of course, is a function of price. What is meant here is that if an
owner of a security wishes to sell it, he must fix his price at an amount which will
yield a return sufficient to attract an investor at the assumed risk level.

\(^{21}\) Risk determination is a highly imprecise matter, and the nature of risk varies
among securities. However, micro-economic theory in recent decades has provided a
practical basis for quantifying the determination of risk, thereby facilitating compari-
son of securities. Instead of being an unarticulated rough approximation, it has be-
come an articulated rough approximation. See J. Lorie & M. Hamilton, The
return for individual companies is termed "fundamental analysis."22

Information about a firm’s projected earnings will have a direct bearing on the estimation of return for investors in its securities, which in turn relates directly to present value.23

Thus, in our example, the estimate that the $20 investment would yield the $32.10 future return enables a determination that the present value was really $30, not $20. The projection of $32.10 (if reliable) is much more relevant than the historical data that last year the same security earned $15. Similarly, soft information bearing on risk (for example, reliance of the firm on one large customer) seems highly relevant to investors. In a word, much soft information is important to fundamental analysis where determinations are made of expected future cash flow and of the risk that the flow will be other than that expected. Given the fact that traditional investment analysis has been fundamental analysis, the materiality of soft as well as hard information to investment decision making is evident.24

From the beginning, the SEC has embraced fundamental analysis through its mandates for disclosure of company-originated data.25 Hence, the Commission, realizing the great rel-

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22. Fundamental analysis involves the analysis of financial statements of a company plus other available data in an effort to find and purchase undervalued securities or to determine overvalued securities in an investor’s portfolio which should be sold. The bible of fundamental analysis is B. GRAHAM, D. DODD & S. COTTLE, SECURITY ANALYSIS (4th ed. 1962). Since a portion of risk may be eliminated through diversification of investments, it is not appropriate to study individual securities without consideration of the investor’s entire portfolio. This fact forms one basis for modern “portfolio theory.” Another basis is the “efficient market hypothesis” which posits that in an efficient market, it is not possible to find underpriced or overpriced securities through analyses of public information. A third basis is a method for determining appropriate investments by ascertaining risks for the portfolio and matching risk preferences of the investor. See J. LORIE & M. HAMILTON, note 21 supra; W. SHARPE, note 12 supra.

23. See Miller & Modigliani, note 13 supra. See also Sprouse, The Importance of Earnings in the Conceptual Framework, J. ACCOUNTANCY, Jan. 1978, at 64, 67. Analysts believe projections to be at the heart of their task. N.Y. SOC. OF SEC. ANALYSTS, ANALYST’S GUIDE TO CORPORATE RELATIONS 4 (Summer 1969), cited in Mann, supra note 4, at 227.

24. There is another traditional school of investment analysis which depends on historical patterns of prices for the particular security—termed “technical analysis.” Technical analysts, or “chartists,” have numerous techniques for extrapolating from charts of past prices which they claim enable them to find underpriced or overpriced securities.

evance of much soft information for fundamental analysis, would doubtless long ago have permitted, if not required, soft data such as projections but for reservations concerning its reliability.

The Advisory Committee, also recognizing the great relevance of much soft data to fundamental analysis, is, in addition, willing to experiment with balancing high relevance against low reliability. Moreover, seeing that the low reliability may lead to investor losses, in turn inducing loss of management credibility with investors and possible litigation, the Advisory Committee suggests permissive disclosure of soft data and a safe harbor for persons publishing such data.

II. RECOMMENDATIONS OF THE ADVISORY COMMITTEE CONCERNING SOFT INFORMATION

Two fundamental questions have been raised concerning the present system of SEC-mandated disclosure of company-originated data: first, whether much of the information required in SEC filings is of little utility to investors, while other data which have been prohibited may be of greater utility; and second, "whether there are presently economic and public policy justifications for the existence of a disclosure system that, at least with respect to company-originated information, is characterized by a strong mandatory dimension regulated by a federal agency";26 that is, should disclosure be mandated by the SEC or instead be permitted on a voluntary basis?27

The Committee concluded that disclosure of more soft information should be encouraged; and, after acknowledging that a negative answer to the second question would lead to elimination of the present mandatory disclosure system,28 a radical result, a majority placed the burden of persuasion on the critics of the present mandatory system and found that that burden had not been met.29 The bases for those conclusions are set forth in the introduction to the Report which gave rise to a characteristically candid dissent by Homer Kripke, in effect stating that the introduction was an afterthought.30 However, there was full concurrence of Committee members with the Report's recommendations that the SEC encourage voluntary and permissive disclosure of soft information.31 Hence, it appears that the one major issue addressed by the Report to the satisfaction of the entire Advisory Committee

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26. REPORT, supra note 3, at V.
27. Id.
28. Id. at II.
29. Id. at V.
30. Id. at D-49. See also Kripke, Where Are We on Securities Disclosure After the Advisory Committee Report?, 6 SEC. REG. L.J. 99 (1978).
31. REPORT, supra note 3, at D-49.
Committee was whether more soft data should be permitted, on a voluntary basis, in SEC filings. The issues which may not have been adequately addressed, in the opinion of some, concern the sufficiency of benefits from mandatory disclosures.

A. What Audience Should the Disclosure System Address?

In arriving at the conclusion that disclosure of more soft data should be encouraged, the Advisory Committee attempts to lay to rest one ghost which should never have arisen, that is, the misconceived notion that SEC disclosure should be for the ordinary person in the street—Main Street, not Wall Street.

The SEC's consistent view, until recently, had been single-mindedly set in favor of making the disclosure system serve the unsophisticated, with the unfortunate consequence that much information of potential value to sophisticates was prohibited on the ground that it might mislead the naive. The view that disclosure should be for the naive reached its nadir in 1972 when the Commission required various pie-charts and other pictographs in disclosure documents. But then the Commission began to recoup when it picked up a suggestion from the Wheat Report

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32. Although the information called for in Schedules A and B of the 1933 Act, 15 U.S.C. § 77aa (1976), and §§ 12-14 of the 1934 Act, 15 U.S.C. §§ 78q, 78n (1976); 15 U.S.C.A. § 78m (West Supp. Pamph. 1977), is historical objective data, both Acts, in these sections, grant broad authority to the Commission to require additional information, and it is believed that there is thus ample authority for compelling soft data. The current view of the SEC, resulting from several changes in the past several years, already permits or mandates much soft information. See note 7 supra.


We now, of course, have the new official position that not only must prospectuses be intelligible to school children, but they must even reach down to the kindergarten set, who have not yet graduated from finger painting. Under the recent guide adopted by the Commission, the drafter of the prospectus must draw pictures to inform the person looking at the prospectus—one cannot say the “reader,” since they assume
that disclosure might be further developed for both the naive and the sophisticated.35 This "differential disclosure" concept has been adopted in numerous ways in the present requirements of the Commission.36

Perhaps it was necessary for the Commission to touch bottom before it could recover from the mistaken notion that disclosure may or should serve the unsophisticated. In any event, the Report now embraces the view that seems to be held by most serious students of securities laws: that disclosure must be and should be for sophisticates who will filter information to the masses and thereby cause the market price to adjust efficiently to the information as interpreted by the knowledgeable.37

In reaching this view, the securities bar may have come full circle, back to what arguably was the original understanding.38

...he will not or cannot read—of the percentage of the equity retained by the promoters and the percentage being sold to the public.

New Approaches to Disclosure in Registered Security Offerings—A Panel Discussion, 28 BUS. LAW. 505, 528 (1973) (remarks of Harold Marsh) [hereinafter cited as Panel Discussion].

35. Some suggested that one problem, how to insulate the naive from sophisticated data which might be confusing, could be resolved by having such data filed with the SEC but not disseminated generally in annual reports or otherwise. This differential disclosure concept was pushed in the 1970s. See Sec. Act Release No. 5427, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,519 (at part entitled "An Approach to Disclosure"); Sommer, Differential Disclosure: To Each His Own, The Second Annual Emmanuel Saxe Distinguished Accounting Lecture, Baruch College, N.Y. (Mar. 19, 1974), abstracted in SEC News Digest 74-55 (Mar. 20, 1974).

The Wheat Report, supra note 6, at 9-10, and Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 565-66 (E.D.N.Y. 1971), both took the view that disclosure must be for the "unsophisticated investor" as well as for the "knowledgeable student of finance."

36. See Sec. Act Release No. 5427, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,519 (explaining differential disclosure). In Accounting Series Releases 147, 148, 149, 163, and 164, the Commission attempts to inform issuers and their accountants as to which matters should be disclosed generally to investors and which may be reserved for analysts, to be filed only with the SEC. [1977] 5 FED. SEC. L. REP. (CCH) ¶¶ 72,169-71, 72,185-86.

37. See REPORT, supra note 3, at D-9, where the Committee states that "[t]he Commission should emphasize disclosure of information useful to reasonably knowledgeable investors willing to make the effort needed to study the disclosures, leaving to disseminators the development of simplified formats and summaries usable by less experienced and less knowledgeable investors."

Harold Marsh said:

It seems to me that the only common sense approach to the question of the audience to whom the disclosure should be directed is that it should be directed to those persons who are capable of understanding the transactions being described .... To attempt to explain to a person who is incapable of understanding is a complete waste of time.


38. The Report refers to the legislative history which indicates that 1933 Act information "is of a character comparable to that demanded by competent bankers
This conclusion of the Report may be one of its more important contributions to disclosure policy. The Report expresses the consensus view of knowledgeable securities lawyers and should be accepted by the SEC and Congress.

This conclusion, that disclosure should be gauged for the people who can comprehend complex financial data, has an important implication: more soft information must be supplied because sophisticates can themselves weigh its relevance against its reliability.39

B. What Soft Information Should Be Disclosed?

What specifically did the Advisory Committee recommend with respect to various categories of soft information?

I. Projections

The SEC, after a brief flirtation with forward-looking information in the mid-1930s, banned projections in filed documents and, for companies "in registration," even in non-filed disclosures.40 Beginning in 1972, however, the Commission attempted to develop a policy concerning disclosure of projections which, after some flowing and ebbing, culminated in the rather inconclusive 1976 announcement which expressly permitted disclosures of projections without encouraging or discouraging them.41 In addition to that policy statement, proposed guidelines which set forth

from their borrowers and has been worked out in light of these and other developments." H.R. Rep. No. 85, 73d Cong., 1st Sess. 4 (1933), quoted in Report, supra note 3, at 564 n.11. See also Wheat Report, supra note 6, at 52-53, cited in Report, supra note 3, at 564 n.11; Douglas, Protecting the Investor, 23 Yale Rev. (n.s.) 508, 523-24 (1933), quoted in Report, supra note 3, at 312-13 (where then Professor Douglas pointed out that sophisticates will cause the market prices of securities to reach a level proper in the light of the disclosed information so that price will be a surrogate for the unsophisticated).

Professor Douglas had nothing to do with drafting the 1933 Act. These authorities fail to make a convincing case that the original draftsmen had in mind the market price surrogate principle; but, in any event, the great growth since 1933 of financial intermediaries such as mutual funds and investment advisors make the surrogate concept more acceptable now.

39. In private offering circulars, which by definition are not regulated by the SEC, and which are prepared for sophisticates, the most important data are projections. See note 82 infra.


It is not clear whether the 1976 changes described in the text below changed the prohibition while "in registration" although the Advisory Committee believes it arguably did. See Report supra note 3, at 360-61. See also note 75 infra.

the requirements of the Division of Corporation Finance were also announced: "(1) that management have a reasonable basis for its projections; (2) that the projections be presented in an appropriate format; and (3) that the accompanying disclosures facilitate investor understanding of the basis for and limitations of projections."42

The Report supports the trend toward more disclosure of projections and recommends that the SEC encourage publication of analytical and forward-looking data on a voluntary basis.43 The Report expressed the hope that, although the proposal was for voluntary disclosure only, market forces, such as investor demand and the firm's own interest in procuring a following by security analysts, would induce disclosure of projections.44 Because the Report views projection disclosure as experimental, it suggests that the Commission monitor the program to determine usefulness, costs, and responsiveness of companies to investors' needs.

Contrary to the 1976 release,45 the Report recommends a "safe harbor" rule for both SEC filings and informal disclosures to remove one obstacle to disclosure of soft information. The safe

42. Id. Although not yet adopted, these guides are being applied by the Division of Corporation Finance. Division of Corporation Finance, Securities and Exchange Commission, Hendricks & Tomlinson Staff Reply, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,664.

The "reasonable basis" suggested by the guides may be a history of operations or experience in projecting and may be supported by an independent outside review by a qualified expert. The format would appropriately include at least forecast revenues, net income and earnings per share presented either in the most probable specific amounts or most reasonable range. The guides suggest that investor understanding may be facilitated by disclosure of the assumptions underlying the projections. Investors should be cautioned against attributing undue certainty to the projections and should be informed of management's plans to update. Also, management should consider analysis of variances between prior forecasts and specific results.

43. Voluntary disclosure was deemed appropriate at this time by the Advisory Committee, because the SEC does not yet have an adequate basis for specific rules and regulations; not all public companies are in a position to disclose projections, and it was felt that none should be compelled to expose themselves to risks of litigation or liability. REPORT, supra note 3, at 354. Another justification is that permissive disclosure was considered an appropriate transitional stage of development from the prior policy of prohibition of projections. Id. at 354. The 1976 projections release suggested that mature companies or those with experience in projections may have a better basis for projections than other companies. Sec. Act Release No. 5699, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,461. But the Advisory Committee disagrees and would permit projections by all public companies. REPORT, supra note 3, at 356-57.

44. REPORT, supra note 3, at 354-55. Entirely apart from legal considerations, many corporate managers believe the publication of projections will result in loss of credibility with investors since projections are highly speculative in most situations. An important legal concern is the potential liability for projections that do not pan out. See note 64 & accompanying text infra.

harbor would be available unless it is proven by the plaintiff that the information was without basis or was disclosed otherwise than in good faith.\textsuperscript{46}

In the 1976 release, the Commission had determined that a safe harbor rule was hardly necessary, given that the law probably would not be changed by a rule which excused only appropriately qualified good faith statements made with a reasonable basis.\textsuperscript{47} However, corporate managers may find more comfort in an explicit rule than in the meager case law from various lower federal courts.\textsuperscript{48}

In any event, there seems little disadvantage to a safe harbor rule except that its application may well be so subjective that its promise will not be fulfilled. This subjectivity is likely to provide cold comfort to sophisticated securities lawyers.

The Report also suggests that disclosure of projections be accompanied by a cautionary statement regarding their inherent uncertainty, as the 1976 proposed guides require\textsuperscript{49} and most commentators recommend.\textsuperscript{50} Although disclosure for sophisti-

\textsuperscript{46} The Report supplies a proposed safe harbor rule in the following form, including not only projections but other soft data:

A statement of management projections of future company economic performance or a statement of management plans and objectives for future company operations shall be deemed not to be an untrue statement of material fact; a statement false or misleading with respect to any material fact; an omission to state a material fact necessary to make a statement not misleading; or the employment of a manipulative, deceptive or fraudulent device, contrivance, scheme, transaction, act, practice, course of business, or an artifice to defraud; as those terms are used in the Securities Act of 1933, the Securities Exchange Act of 1934, or the Public Utility Holding Company Act of 1935, or rules and regulations thereunder, unless such information: (1) Was prepared without a reasonable basis; or (2) Was disclosed other than in good faith.

\textsuperscript{47} Sec. Act Release No. 5699, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,461. \textit{See generally} notes 79-119 & accompanying text infra. Although it has withdrawn the proposed safe harbor rules for projections, the Commission is of the view that reasonably based and adequately presented projections should not subject issuers to liability under the securities laws, even if the projections prove to be in error. The Commission realizes that even the most carefully prepared and thoroughly documented projections may prove inaccurate.

\textsuperscript{48} It is possible that the securities law provisions immunizing persons who rely on SEC rules would give independent authority to the safe harbor rules. \textit{See} § 19(a) of the 1933 Act, 15 U.S.C. § 77s(a) (1976); § 23(a) of the 1934 Act, 15 U.S.C. § 78w(a) (1976). \textit{But see} text accompanying note 104 infra.


\textsuperscript{50} \textit{See} Report, supra note 3, at 357 n.19, A-301 n.3; \textit{cf.} id. at A-321 n.5 (suggesting investors may not be as gullible as the Commission assumes).
cates does not require this cautionary note, it is probably not a costly requirement.

Surprisingly, and without much defense of its view, the Advisory Committee advises against compulsory disclosure of assumptions underlying projections, although the materiality of assumptions in assessing forecasts is acknowledged. The justification is lack of Commission experience and the Advisory Committee's hope that minimizing requirements will maximize voluntary projections. In accordance with the SEC's 1976 proposed guides, comparison with actual results on a voluntary basis is recommended.

The Advisory Committee offers several other specific proposals concerning projections:

b. The items of information to be forecasted should rest within the discretion of management, but should be those most relevant in evaluating the company's securities and should not be items whose projection would create materially misleading inferences;

c. Third party review of management projections should be permitted but not required;

d. Projections previously issued by management having currency at the time a registration statement is filed should be required to be included in the registration statement in their original form, or where necessary, in modified form;

e. The time period to be covered by the projection should rest within the discretion of management; and

f. Inclusion of projections in one Commission filing should not "lock" the registrant into including projections in future filings; likewise, registrants should be permitted to resume the inclusion of projections in filings after a prior discontinuance. However, companies should be encouraged not to discontinue or resume projections in filings without good cause.

Given the great relevance and perhaps greater unreliability of projections, it is likely the battle over the role of projections as disclosure information will continue. Perhaps a second experi-

51. Id. at 358.
52. Id.
53. Id. at 359.
ment involving mandated disclosure will be necessary. Even then, one suspects that the tension between investors, who would like to know the future, and management, who are not seers, will never be resolved satisfactorily.

Nevertheless, the Report's recommendation that voluntary projections be permitted and facilitated by the SEC seems correct: indeed, the only clearly incorrect recommendation would have been a proposal to revert to prohibition of projections. Any experience gained from disclosure of voluntary projections will aid in formulating further steps. However, there is a subtle problem even with permissive disclosure. A company will no longer be able to defend a non-disclosure suit on the ground that disclosure is prohibited.55

2. Management Analyses

The Report recommends the continuance of mandatory disclosure for managements' analyses of financial information.56 The purpose of the management analysis requirement holds high promise; it is designed to cause the people who know the hidden facts behind the financial statements to give their special knowledge of why that data should be interpreted in one way rather than another.

It is probably fair to say that to date these analyses have been nothing but banalities. The Report recommends amendments to change the present boiler-plate character and to make them more meaningful to readers. First, the Report states that management should be given broader latitude in drafting. Second, it suggests that the SEC recognize two separate aspects of the management summary, quantitative analysis57 and historical data; both to be presented on a segmented basis. Third, the Advisory Committee recommends that the Commission induce staff review consistent with the spirit of the requirement.58

56. These are now required. Guide 1, note 7 supra; Guide 22 (1933 Act), note 7 supra.
57. By "quantitative analysis," the Committee apparently means the present Guide 22 requirement of disclosure of amount of change between accounting periods, for example, of all items of revenue and expense, and advising that a change should generally be discussed if the item increased or decreased by more than 10% relative to the prior period or by 2% of average net income or loss for the most recent three years presented.
58. The proposed guide reads:

**MANAGEMENT ANALYSIS OF THE FINANCIAL STATEMENTS AND FORWARD LOOKING INFORMATION**

Provide an analysis for each business segment of the reported financial
A further innovation seeks to underscore to management the importance attached to the analysis. The SEC would require a letter from the chief financial or accounting officer stating that due regard had been given to the requirements of this analysis and particularly to that part which calls for the disclosure of any facts and contingencies known to management which would make the historical record not indicative of the future.59 Interestingly, the Advisory Committee also recommends a "sunset" provision for this letter requirement, suggesting that it be discontinued in three years unless expressly extended by the Commission.

It has been said that one can lead a horse to water but cannot make him drink. However, management may thirst for investor approbation, and it would seem that no single disclosure device has more potential than the management analysis. What could be more meaningful than for investors to get the same inside information managers have often supplied to friends and relatives? Nevertheless, we may expect substantial opposition from financial officers concerning the "due regard" letter. It not only smacks of petty tyranny but may have the sting of personal liability which only a few masochists enjoy. The three-year sunset provision is a welcome suggestion.

Instructions. 1. The analysis of material periodic changes (a) should explain material increases or decreases in discretionary items such as research and development costs, advertising expenses, and maintenance and repair expenses, and (b) should break down variances into components, such as the amounts by which changes in prices and changes in volume resulted in a material change in sales.

2. The analysis should focus on facts and contingencies known to management which would cause reported financial statements to be not indicative of future operating results or of future financial condition. This would include description of and amounts of (a) matters which will have an impact on future operations or financial condition and have not had an impact in the past, and (b) matters which have had an impact on reported financial statements and are not expected to have an impact upon future operations or financial condition. The form and content of disclosures pursuant to this item will necessarily vary among registrants and will change from period to period for the same registrant as circumstances change. In general, the disclosures should be similar to that which the chief executive officer might prepare for the board of directors of a company. Both quantitative analysis and narrative discussions are important.

REPORT, supra note 3, at 368-69.

59. Id. at 374.
3. Dividend Policy, Capital Structure Policy, and Plans and Objectives

In other departures from existing policy, the Advisory Committee recommends permissive disclosures of dividend policy,\textsuperscript{60} capital structure policy (e.g., proportion of debt to equity), and “plans and objectives” generally.\textsuperscript{61} Specifically, it recommends five-year planned capital expenditures budgets and methods of financing by business segment, indicating (a) amounts thereof related to production on the one hand and to environmental control facilities, on the other, and (b) the expected effects on productive capacity.\textsuperscript{62} These all would be within the safe harbor rule described in the projections section above.\textsuperscript{63}

Assuming that investors will engage in some form of fundamental analysis, these recommendations for increased disclosure will greatly increase the available relevant evidence of a firm's prospects, albeit with less than fully reliable data. Moreover, the experiment will test the hypothesis of those critics who suggest that market forces will cause managers to disclose meaningful data. And, to the extent disclosures are in fact made, experience with them may reveal the need to take additional steps to further encourage, mandate, or prohibit disclosure. A period of experimentation will also allow more time for necessary research on

\textsuperscript{60} At present, the note to rule 14a-9, 17 C.F.R. § 240.14a-9, note (1977), states the SEC's long-standing policy against predictions as to specific future dividends, and Guide 26 under the 1933 Act, Guide No. 26 for Preparation and Filing of Registration Statements, Sec. Act Release No. 4936, [1978] 1 FED. SEC. L. REP. (CCH) \textsuperscript{3786}, outlaws projections of future dividends, although it permits a statement of policy to declare dividends as a percentage of profits.

\textsuperscript{61} These include: (1) plans for product development, marketing programs, methods of financing, personnel, and general business strategy; (2) plans for expansion, contraction or redirection of the business; (3) plans for the acquisition of other companies, which may or may not have been specifically identified; (4) plans involving the disposal of existing assets; and (5) plans regarding distribution of dividends to stockholders.

\textsuperscript{62} The proposed instruction reads:

\textit{ITEM 9. MANAGEMENT ANALYSIS OF THE FINANCIAL STATEMENTS AND FORWARD LOOKING INFORMATION.}

\textit{Instruction 4.} Registrants are encouraged, but not required, to furnish for each business segment a description of planned capital expenditures and financing for (1) the current fiscal year and (2) the succeeding four year period. If this information is furnished, it would be desirable to disclose the amounts related to environmental control facilities and the expected effects upon production capacity, and to furnish an analysis of differences for the most recent fiscal year between previously disclosed budgets and actual capital expenditures.

\textsuperscript{63} \textit{Id.} at 375-79.
portfolio analysis which, if its adherents' views are upheld, might obviate the need for firm-oriented disclosure.

The Report, whatever it lacks in other ways, cannot be faulted for proposing careful, yet progressive experimentation.

III. DUTIES TO DISCLOSE SOFT INFORMATION TRUTHFULLY

There are two distinct disclosure systems under the securities laws: (a) disclosure mandated or permitted by statutory or regulatory provisions, and (b) disclosure induced by potential fraud liabilities.64

If the SEC accepts the Advisory Committee's recommendations to permit and encourage, but not mandate, disclosure of soft information in SEC filings and elsewhere, issuers will of course be concerned about the risks of fraud liability and the costs of litigation from such disclosure or failure to disclose.65

There are two broad types of fraud liability: for affirmative misrepresentation and for failure to disclose. Because of the latter, when the SEC merely permits disclosure, it may be that in several contexts this permission, in conjunction with fraud liability for failure to disclose, mandates disclosure. In other words, removal of prohibitions against disclosure may give reign to the coercive effect of fraud liability for mere silence concerning soft data when there is a duty to disclose material information.

Hence there are two reasons for considering the potential fraud liability for soft data: (a) to examine the exposure to liability from publication of soft data; and (b) to determine when, if ever, disclosure of soft information will be mandatory and not just permissive.

Several types of cases have arisen concerning misrepresentation in securities transactions; but the most important for our purposes are cases of (1) affirmative misrepresentation, (2) failure to disclose in conjunction with insider trading or tipping, and (3) the issuer's affirmative duty to disclose.

As to affirmative misrepresentation, any person who misrepresents material information, thereby damaging another, may be liable on various statutory and common-law grounds to that other person who buys or sells securities, depending on whether the misrepresentation was made negligently or with scienter, whether the parties were in privity or had some other relationship, and whether the loss transaction was causally connected with the mis-

64. Id. at XLIII-XLV.

65. Legal liability and cost of litigation are but two costs. Issuers will also be interested in determining the costs of producing such data and the other costs and benefits disclosure may bring.
representation. The second category, insider trading or tipping, includes not only the conventional case of an insider who trades on the basis of undisclosed inside information or tips a confidant who trades, but also certain other cases in which a person having a special relationship to an issuer while in possession of material inside information acquires or disposes of securities. For example, this category includes cases in which a company causes a redemption or other repurchase of its own shares without disclosure of material inside information.

In the first category, there is an affirmative misrepresentation, but the alleged wrongdoer need not have engaged in a purchase or sale transaction. In the second category, no affirmative statement is required for liability to be imposed, but here there must be an affirmative act: a purchase or sale transaction by the insider or tippee. In the third category, the issuer's affirmative duty to disclose, which so far is quite unsettled, the question is whether an issuer of securities who is neither trading (or tipping) nor making any statements can be held liable for its silence to investors who do trade at prices different from what they would have been had the issuer publicly disclosed certain information. In each of these categories, there are special problems when the material information which is misrepresented or not disclosed is soft information.

A. Affirmative Misrepresentations

1. Is it Necessary That Soft Information Be a "Fact"?

Most statutory and common-law articulations of rules against misrepresentation refer to misrepresentation of a "material fact." However, the "material fact" requirement is merely a convenient way of describing what is capable of misleading a person, and courts' analyses, for the most part, have acknowledged this. Many courts have attempted to distinguish "fact" from "opinion," or "fact" from "prophecy," and so on, without much comprehension of the function of words. There is a distinction to be made. It is not for the sake of sterile classification of facts and non-facts, but for the purpose of distinguishing those utterances or non-utterances which reasonably have a capacity to mislead from those

67. See, e.g., Drachman v. Harvey, 453 F.2d 722, 737 (2d Cir. 1972) (en banc).
68. See generally 2 Bromberg, supra note 66, § 7.6(1).
which have no such misleading power.\textsuperscript{70} It should thus be apparent that the important question is materiality, that is, whether there is a substantial likelihood that a reasonable mind would consider the datum important in making the investment decision.\textsuperscript{71} If the datum is important in the decision-making process, it could mislead if erroneous or omitted.

To illustrate, in \textit{First Virginia Bankshares v. Benson},\textsuperscript{72} Walter E. Heller & Co. was sued by a plaintiff who relied on an inaccurate description of the relationship between Heller and its debtor-customer, whose shares the plaintiff purchased. Heller had stated to the plaintiff that it would be willing to loan more money to the customer, that the relationship with the customer had been satisfactory, and that the customer ran an "above-average operation" and had always been prompt in meeting its obligations. In fact, Heller suspected the customer's books of being false, payments were three weeks in arrears, and three of the customer's checks had bounced.\textsuperscript{73}

The trial judge in his oral charge to the jury accurately, although inartfully, captured the true principle that an opinion, and not only a fact, may be a basis for recovery under rule 10b-5. He then went on, "I do caution you, however, that if it's an opinion that is the basis for the claim, you still would have to decide that that's a material matter that somebody's opinion is material in a particular case."\textsuperscript{74}

The appellate court affirmed, but, not appreciating the point, stated the conventional nonsense that the characterization of Hel-
ler's statement as fact or opinion is "particularly crucial." Nevertheless, the court avoided error by saying these "should be classified as fact, rather than opinion, for present purposes." This appears to be an unnecessary legal fiction.

For a further example, consider a sales projection by the sales manager of a firm, published in the advertising section of a newspaper and aimed at consumers of the company's product. The projection would be different in quality from the same statement made by the chief executive officer to a meeting of financial analysts. A court that would be concerned with whether either is a "fact" or an "opinion" would be focusing on the wrong issue and, thus, wasting resources; and possibly it could arrive at the wrong result. The correct question is simply whether the projection reasonably could mislead. Thus, even if the sales manager's projection were held not actionable, if a prospectus quotes him in a way which would induce reliance, it should be actionable in that context. One may imagine the tortuous reasoning a court might find necessary, if, in the case when the sales manager's projection appeared in the newspaper ad, the court held that there was no liability because it was merely an opinion. When the prospectus case arises, could the court there hold that a "fact" is involved?

75. Id. at 1318. See also Marx & Co. v. Diners' Club, Inc., 550 F.2d 505, 514 (2d Cir.), cert. denied, 434 U.S. 861 (1977) (representations to a securities buyer that a favorable takeover by another company would probably occur held not a "fact"); Marx v. Computer Sciences Corp., 507 F.2d 485, 489 (9th Cir. 1974) (quoting from and following G & M, Inc. v. Newbern, 488 F.2d 742 (9th Cir. 1973), for the proposition that a projection may be a "fact"); Black v. Riker-Maxson Corp., 401 F. Supp. 693, 699 (S.D.N.Y. 1975) (question of whether earnings projection was "fact" or not treated separately from materiality). Judge Doyle, on the other hand, in Nicewarner v. Bleavins, cautiously and skillfully avoided the necessity for characterizing certain soft information as fact or non-fact, finding another basis for non-liability. 244 F. Supp. 261, 264 (D. Colo. 1965). One trial court's instruction was particularly confused:

"Statements about the future growth and development of a company are classed as opinions or facts, depending upon the circumstances under which they were made. No recovery may be based on an expression of opinion . . . unless the opinion was completely unfounded and reckless, or unless it was deliberately intended to be misleading. The plaintiffs can also recover if you believe that the defendants gave any definite opinions or assurances about the future which they thought were false when they made them."


The SEC has used language supporting the view that the emphasis is on "material" and not "fact" by referring to "material information." Investors Management Co., 44 S.E.C. 633, 634 (1971); accord, In re The Boston Co. Inst. Investors, [Current] FED. SEC. L. REP. (CCH) ¶ 81,705, at 80,854, 80,856 (1978).

76. To obviate the problem, the American Law Institute proposed the following definition: "'Fact' includes (a) a promise, prediction, estimate, projection, or forecast, or (b) a statement of intention, motive, opinion, or law." ALI FED. SEC. CODE § 256 (March 1978 Proposed Official Draft).
2. When Is An Incorrect Material Soft Datum Misleading?

When a published projection or some other item of soft information not objectively true or false when made fails to eventuate, under what circumstances will it be considered to have been misleading when made? For some time there had been a school of thought, sanctioned by the SEC, which held that projections and other similar soft information in SEC-filed documents were per se misleading. This was evidenced by the famous note (a) to rule 14a-9 of the Proxy Rules which formerly stated that “Predictions as to specific future market values, earnings or dividends” may be misleading.77

Some courts subscribed to that view. A frequently cited example is *Union Pacific Railroad v. Chicago & North Western Railway Co.*78 The *Union Pacific* case involved a contest to take over the Rock Island Railroad and a contested proxy solicitation for approval of a merger of the Rock Island with the plaintiff, Union Pacific Railroad Company. The defendants, North Western and its allies, had predicted savings of twenty-five million dollars if their own offer were to be accepted in substitution for the Union Pacific merger offer and another fifty million dollars if a contemplated additional merger were to occur. Defendants also had predicted subsequent share prices and specific earnings for their proposed merged company. The court quoted Note (a) to Rule 14a-9, stating that it would pay great deference to the SEC, and held “that such predictions mislead by conveying a certitude which inherently they cannot possess.”79 This view of projections has now been disavowed by the Commission80 and seems not to have been followed by other courts.

Somewhat anomalously to the Commission’s original view as evidenced in the *Union Pacific* case, informal publication of soft information (that is, outside SEC filings) has never been considered by the SEC or the courts to be per se misleading.81 Permit-

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77. 17 C.F.R. § 240.14a-9, note (1977); see note 58 supra. The Commission had read the Note to prohibit projections, although the language is ambivalent. Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1292 (2d Cir. 1973). See also Brief of Amicus Curiae SEC, Sunray DX Oil Co. v. Helmerich & Payne, Inc., 398 F.2d 447 (10th Cir. 1968).

78. 226 F. Supp. 400 (N.D. Ill. 1964).

79. Id. at 409. Professor Kripke states that this case held “that a projection was misleading just because it was a projection, entirely apart from the question whether in fact it might have been sound.” Kripke, *The SEC the Accountants, Some Myths and Some Realities*, 45 N.Y.U.L. REV. 1151, 1198 (1970).


81. There is an exception. As part of its precarious resolution of the dilemma caused by the conflict between the affirmative disclosure rules and the “gun-jumping”
tting informal disclosures of soft information while prohibiting filed disclosures seems ill-conceived. One would rather have projections appear in filed documents where they will receive SEC scrutiny and policing.

Another potential line of development on this issue of when soft data is a misrepresentation was formulated in *Beecher v. Able*, in which the parties had stipulated that there no longer was a legal prohibition of projections of future earnings in a prospectus. The court held that projections must be based on facts making realization "highly probable," thus practically outlawing forward-looking data for all but a few situations.


Now that the SEC has discontinued its prohibitions on projections in filed documents, on the apparent basis that they are no longer per se misleading, it should reconsider its express ban on informed projections when a company is in registration. Although the gun-jumping question is concerned with whether the company is making a selling effort prior to the filing of the registration statement in violation of § 5(c) of the 1933 Act, 15 U.S.C. § 77e(c) (1976), the Report recommends that the SEC permit companies to revise publicly (but presumably not to originate) projections during the pre-filing period. *Report*, supra note 3, at 361. *See also* note 39 supra.

82. The disclosure practice for private offerings illustrates (a) the inapplicability of the old SEC prohibition of forecasts to unfiled disclosure documents, and (b) the unreality of the SEC view. Thus, in private placement offering statements (used to satisfy the "access to information" requirement for private offerings under SEC v. Ralston Purina Co., 346 U.S. 119 (1953)), sophisticated private placees have always demanded and received projections because they consider them relevant.

There has been some suggestion that long-term projections may at least in some cases be almost fraudulent per se on the theory that there can be no reasonable basis for believing them to be sound. Nonetheless, the usual private placement purchaser ordinarily will not even consider a purchase unless he is furnished with long range forecasts running up to five and sometimes ten years.

P.L.I. FIRST ANNUAL INSTITUTE ON SECURITIES REGULATION 42 (1970). "While an S-1 must avoid any projections or forward looking information, the detailed projection and the underlying basis for it will be one of the most important types of information for the sophisticated venture capitalist." P.L.I. SECOND ANNUAL INSTITUTE ON SECURITIES REGULATION 52 (1971).

84. *Id.* at 346.
85. *Id.* at 346, 348.
86. In *Beecher*, the plaintiffs purchased debentures in a registered offering in July 1966, and sued under § 11 of the 1933 Act, 15 U.S.C. § 77k (1976), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1977), claiming that misrepresentations were made in the registration statement which noted various production-delay problems and stated, "it is very likely that net income, if any, for fiscal 1966 will be nominal." 374 F. Supp. at 345. In fact, a $52 million loss was ultimately reported.

The court, in its opinion on the § 11 claim, found as a fact that the quoted statement would be read as a forecast that the company would break even—which was what the company's internal projections also indicated. *Id.* at 347. Echoing the rea-
However, the Beecher "highly probable" test has not been followed by other courts. Rather, the courts have attempted to formulate standards based on good faith and the reasonableness of the basis for the projection and of the form in which it is communicated. Although the cases are as yet inconclusive, it appears likely that the courts eventually will settle on a rule which would find forecasts which fail to eventuate to be untrue statements if: (a) not made in good faith; or (b) the forecast lacks a reasonable basis in underlying data or method of preparation; or (c) it is inadequately explained and qualified. Furthermore, these requirements probably will be held to define what is a misrepresentation and will not be considered defenses. As such, they will be part of a complainant's case-in-chief on which he will have the burdens of pleading, going forward with the evidence, and persuasion.

An examination of some of the opinions which point toward these principles follows.

a. **Good Faith and Reasonable Basis.** The decisions seem to agree on the requirement of good faith, that is, at least an honest belief in the forecast or other item of soft data. Thus in

soning behind the Union Pacific-SEC approach described above, the court recognized that projections are highly tentative but stated, "However, investors are likely to attach great importance to income projections because they speak directly to a corporation's likely earnings for the future and because they are ordinarily made by persons who are well-informed about the corporation's prospects." Id. at 348. Instead of holding projections misleading per se, the court held, "[therefore [that] a high standard of care," should be imposed. Id.

87. The American Law Institute adopts this view (except for the third element, which it leaves to agency rulemaking), stating: "A statement of a fact within the meaning of section 256(a) is not a misrepresentation if it (1) is made in good faith, (2) has a reasonable basis when it is made, and (3) complies with any applicable rule so far as underlying assumptions or other conditions are concerned." ALI FED. SEC. CODE § 297(b) (March 1978 Proposed Official Draft).

88. Section 3-17(g) of Regulation S-X, 17 C.F.R. § 210.3-17(g) (1977), also places on the plaintiff the burdens for statements of replacement cost of plant and inventories.

89. Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1040 (7th Cir.), cert. denied, 434 U.S. 875 (1977); Marx v. Computer Sciences Corp., 507 F.2d 485, 490 (9th Cir. 1974); REA Express, Inc. v. Interway Corp., 410 F. Supp. 192, 196, 197 (S.D.N.Y.), rev'd on other grounds, 538 F.2d 953 (2d Cir. 1976) (all three of which would find the soft datum untrue when it does not eventuate and there is neither good faith belief in its accuracy nor reasonable basis for its determination). See also SEC v. Pelorex Corp., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,122 (S.D.N.Y. 1973) (consent judgment for failure to update obsolete projections).

The general principle of a good faith requirement is settled in cases holding that a false statement of present intention is fraudulent. E.g., A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967); Stratton Group Ltd. v. Sprayregen, [Current] FED. SEC. L. REP. (CCH) ¶ 96,302, at 93,016-17 (S.D.N.Y. 1978). In several other cases, it has been held that there was good faith belief in the datum stated and that, even though it did not eventuate, it was not a misrepresentation. Polin v. Conductron Corp., 552 F.2d 797 (8th Cir.), cert. denied, 434 U.S. 857 (1977); SEC v. Geotek, 426 F. Supp. 715
United States v. Grayson, a case involving extravagant claims of expectable future oil royalties, Judge Learned Hand said:

As we understand it, Grayson's objection is... that opinions, promises, or representations as to the future, will not support a charge of fraud. We have repeatedly held the opposite. Indeed, it has been the law ever since 1896, that to promise what one does not mean to perform, or to declare an opinion as to future events which one does not hold, is a fraud.

But what if, despite innocence, a forecast is published and it has no reasonable basis either in fact or in method of computation?

A priori good faith ought not to suffice in every case. It is generally accepted that fraud includes statements innocently made when there is no basis for knowing whether the statement is true.

In Marx v. Computer Sciences Corp., a forecast of earnings was held misleading when, at the time, the company (CSC) had not met internal projections or attained its anticipated market share, had been running deficits of $500,000 per month for several months, and had had marketing difficulties with one of its prod-


Because some fault, either negligence or scienter, is required for liability to be imposed under most common-law or securities-law liability provisions, the element of untruthfulness involving bad faith will often be intertwined with the element of defendant's fault. See, e.g., Marx v. Computer Sciences Corp., 507 F.2d 485, 490 (9th Cir. 1974). In a related area, the SEC long ago had established that broker-dealers' forecasts of earnings must be in good faith and have a reasonable basis. E.g., Kahn v. SEC, 297 F.2d 112 (2d Cir. 1961). These requirements are based on the "shingle theory." "In brief, the theory is that when a broker-dealer goes into business (hangs out his 'shingle') he impliedly represents that he will deal fairly and competently with his customers and that he will have an adequate basis for any statements or recommendations which he makes concerning securities." R. Jennings & H. Marsh, Securities Regulation 676 (4th ed. 1977). See generally Cohen & Rabin, Broker-Dealer Selling Practice Standards, 29 Law & Contemp. Prob. 691, 704-05 (1964); see also I Bromberg, supra note 66, § 5.3, at 97-98. A broker-dealer's projection "will be fraudulent if it is not honestly held... [I]t must have some combination of these factors, all in reasonable measure: (1) factual or historical basis, (2) investigation, and (3) sensible method of computation or formation." Id. Although these cases generally involved huge predicted increases of prices or earnings, the underlying principles seem equally applicable to an issuer's own statements, whether or not within more conservative bounds.

90. 166 F.2d 863 (2d Cir. 1948).
91. Id. at 866. See also W. Prosser, Handbook of the Law of Torts 701 (4th ed. 1971).
92. "Reasonable basis" must mean not only that the datum is based on sound factual grounds but that the method of deriving the datum is sound. Marx v. Computer Sciences Corp., 507 F.2d 485 (9th Cir. 1974).
93. E.g., Rolf v. Blyth, Eastman, Dillon & Co., 570 F.2d 38 (2d Cir. 1978); State St. Trust Co. v. Ernst, 278 N.Y. 104, 112, 15 N.E.2d 416, 418-19 (1938); Restatement (Second) of Torts § 526(b), (c) (1976).
94. 507 F.2d 485 (9th Cir. 1974).
ucts for which $7,000,000 in research and development (R&D) costs were being carried as an asset. CSC had even considered abandoning the project. The company had stated that, in accordance with its usual accounting practice, when the system became fully operational, it would begin amortizing the $7,000,000 and that this would be done beginning in October of that year. Some months later, estimates of $105,000,000 in revenues and one dollar per share earnings for the year were also published. But, at that time, CSC had not disclosed that the system was not operational and that R&D costs were not yet being expensed.95 Plaintiff purchased 2,000 shares after hearing the two forecasts, believing the R&D was being expensed and that profits of one dollar per share after such expensing nevertheless were anticipated. When the system was abandoned almost immediately thereafter, earnings were reported at $0.41 instead of $1.00 per share after a write-off of the R&D.

Summary judgment for the defendant was reversed, the court stating that if either good faith or reasonable basis was absent, there was a misrepresentation:

The next question is, was the forecast an “untrue” statement. Of course in hindsight it turned out to be wrong. But at least in the case of a prediction as to the future, that in itself does not make the statement untrue when made. However, the forecast may be regarded as a representation that on January 23, 1970, CSC's informed and reasonable belief was that at the end of the coming period, earnings would be approximately $1.00. That is what a reasonable investor would take the statement to mean, and we believe it would be “untrue” when made if CSC did not then believe earnings would be in that amount or knew that there was reason to believe they would not be.96

This established the good faith requirement. The court also went on to require a reasonable basis, saying: “In addition, because such a statement implies a reasonable method of preparation and a valid basis, we believe also that it would be ‘untrue’ absent such preparation or basis.”97

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95. In fact, this information was disclosed at an analysts' meeting but not otherwise, and the plaintiff did not learn of it.
96. 507 F.2d at 489-90.
97. Id. A case illustrating satisfaction of the reasonable basis concept is Dolgow v. Anderson, 53 F.R.D. 664 (E.D.N.Y. 1971), aff'd per curiam, 464 F.2d 437 (2d Cir. 1972). The issue was whether the case against Monsanto Co. for allegedly misleading sales and earnings projections could properly be denied class action status even though defendant's motion for summary judgment should be denied. The court, in denying class action status, held that the plaintiffs had failed to show "a substantial possibility that they will prevail on the merits." Id. at 669. The court expressly found that defendant's internal data justified the forecasts, which were sound when made, and were "reasonable and sound and well within the realm of normal business judgment." Id. at 670. The forecasting process included development and multiple reviews on a continuing basis of a long-range plan, budgeted sales and earnings, and
What of the case where good faith is clearly present but circumstances are such that it is impossible to establish a very reliable basis for the soft datum and that impossibility is disclosed? For example, in the program-costing method, costs for tooling-up and other preparation for production, as well as actual initial production costs, are allocated over future periods proportionately to expected future sales. However, a product may be so new and unusual, and the market so untried, that it is impossible to ascertain with any degree of certainty the probabilities for sales. Yet, management may feel it desirable to suggest that profits are hoped for, with full explanation of all the uncertainties. Would such a statement be a misrepresentation?

In Polin v. Conductron Corp., the Eighth Circuit in similar circumstances held there was no misrepresentation as long as the forecast was made in good faith. Similarly in SEC v. Geotek, an oil drilling fund prospectus stated: "[w]hile it is not possible to predict accurately at this time the allocation of net proceeds, it is estimated that approximately . . . 5% [of such proceeds will be utilized] for general and administrative costs." The SEC contended that the five percent estimate was not feasible and that prior programs' general and administrative costs had been closer to thirty percent. The court held:

[T]here is insufficient evidence to show that the 5% estimate . . . was other than a good faith estimate of general and plant replacement and development budgets. The court found that these "were made honestly, were reasonable, and were the best estimates of the people in Monsanto most qualified to make them." Id. at 676. Further, it was held that these were "fully supported by Monsanto's internal estimates and current experience," and changes were currently and fully disclosed. Id. at 677.

Since reasonableness of basis must mean reasonable under the circumstances, it is not expected that every projection must be as carefully prepared as in Dolgow. With this reasonable basis requirement, contrast the Beecher v. Able requirement, see note 86 supra, that the forecast must have a high probability of being attained.

Concerning reasonableness of basis, consider the case of the president of one listed company who, after stating a 1978 projection, said: "We exceeded our 1977 predictions, and we are completely confident that we will also exceed our predictions for 1978."


98. See generally T. FIFLIS & H. KRIPKE, ACCOUNTING FOR BUSINESS LAWYERS 190 (2d ed. 1977).

99. Of course, if the person who issues the qualified statement is in fact in possession of additional data which would alter the statement, it may be a misrepresentation to fail to disclose the additional data. Cf. Lynch v. Vickers Energy Corp., 383 A.2d 278 (Del. 1977) (company owes a duty of "complete candor," see note 135 infra).

100. 552 F.2d 797 (8th Cir.), cert. denied, 434 U.S. 857 (1977).


102. Id. at 753 (emphasis added).
administrative costs, made by management and its legal counsel, based upon certain new cost-cutting programs and an anticipated increase in the sale of partnership interests in the 1971 programs . . . . 103

These results indicate the misrepresentation may be avoided even when a projection is without a foundation, at least where the lack of foundation is made reasonably apparent to investors.104 Even Beecher v. Able105 might excuse the utterance. The court there said it would require disclosure of "any assumptions underlying the projection . . . if their validity is sufficiently in doubt that a reasonably prudent investor, if he knew of the underlying assumptions, might be deterred from crediting the forecast. Disclosure of such underlying assumptions is " . . . necessary to make . . . [the forecast] . . . not misleading . . . ."106

But, possibly, such a disclosure of lack of basis will not avoid a finding that the datum is an untruthful statement. This result is especially likely to follow if the court accepts the view that even naive investors are to be protected.107 Of course, a disclaimer still runs the risk of being held an invalid waiver;108 and, moreover, the representation that a waiver has been made may be fraudulent.109

b. Explanation, Qualification, and the Burden of Proof:
Good faith and reasonableness of the basis cannot suffice in every case to avoid a misrepresentation. For example, a forecast that sales will increase $10,000,000, even if in good faith and reason-

103. Id.

Nicewarner v. Bleavins, 244 F. Supp. 261 (D. Colo. 1965), may be thought to rest solely on a good faith requirement with no need to show reasonable basis for the projection, but it probably does not stand for that proposition. As a basis for holding that no liability had accrued for statements concerning predicted profits, production scheduling, likelihood of success, and anticipated marketing arrangements, the court concluded that the statements were made in good faith and that "it does not appear that [defendant] could have known of their untruth by taking reasonable precautions." Id. at 264. However, the court may have had an unstated rudimentary "reasonable basis" factor in mind, for it noted that "there were circumstances which made the statements believable." Id. at 264. It also pointed out: "[S]everal models of the [item to be produced] were tested, and the indications were that remaining difficulties could be eliminated. Plans for nationwide and even international distribution were mapped out with companies and individuals capable of undertaking such an extensive operation." Id. at 264. The case is probably best understood as one in which the skimpy basis for the statement made was sufficient, because the statement did not purport to represent anything more than what in fact was true.


106. Id. at 348 (emphasis added).

107. See text accompanying notes 32-39 supra.


ably based, may be misleading if there is no disclosure that cost of goods sold will also increase by $10,000,000. Such a forecast would be a half-truth. Other cases may include the need to disclose assumptions on which there is room for a difference of opinion; for example, an assumption that interest rates will drop, if included in an earnings projection, would seem to require disclosure of that assumption in any case. Thus, the concept of the half-truth has an important application to soft data, that is, qualifying data must be disclosed.

Although few cases speak of this as a third requirement for avoiding untruth,\footnote{110} the SEC in its release of Proposed Guide 62 for projections included the statement that “[T]he Commission will not object to disclosure in filings with the Commission of projections which are made in good faith and have a reasonable basis, provided that they are presented in an appropriate format and accompanied by information adequate for investors to make their own judgments.”\footnote{111} The commentators, also, generally have stated that qualifying data and contextual format must be disclosed.\footnote{112}

In any event, these requirements of good faith, reasonable basis, and appropriate qualification should be considered elements of the complainant’s case—the showing that a misrepresentation has been uttered. Hence, the plaintiff should have the burdens of

\footnote{110}{In Marx v. Computer Sciences Corp., the court stated: Whether CSC should have publicized all or some of the particular problems it was experiencing with CT presents a nice problem. A company, of course, need not detail every corporate event, current or prospective, which has or might have some effect upon the accuracy of an earnings forecast. It must disclose only those facts which are material. While we consider it doubtful that the failure to disclose any one of the distinct problems besetting CT, taken by itself, would constitute an actionable material omission under the rule, we nevertheless cannot say as a matter of law that the failure to disclose some or all of them would not influence the decision of a reasonable investor. An earnings forecast is a shorthand description of the general financial well-being of a company; it creates an influential impression of the condition of the company in the eyes of the investing public. Under the statute and rule, when an earnings forecast is made, such facts should be disclosed as are necessary to allay any misleading impression thereby created. In this case, whether the failure to disclose the existence and nature of each of CT’s problems, or any partial combination of them was an omission “to state a material fact necessary in order to make the statements made . . . not misleading” is a factual determination properly left to the jury. 507 F.2d 485, 491-92 (9th Cir. 1974) (omission in original) (footnotes omitted). Beecher v. Able, 374 F. Supp. 341 (S.D.N.Y. 1974), required disclosure of assumptions when necessary to make the forecast not misleading. See note 80 supra.}


\footnote{112}{2 Bromberg, supra note 66, § 7.2(1), at 148-49. See also N.Y. Stock Exchange Company Manual A-22 (1977) (requiring that any projection be “appropriately qualified”).}
pleading, going forward with the evidence, and persuasion. The SEC's safe harbor rule for replacement cost and Proposed Guide 62 for projections, as well as the Advisory Committee's proposed blanket safe harbor all place these burdens on the plaintiff. However, the point deserves mention because many apparently thought that the defendant must establish his innocence.

Another consideration which suggests that placing these burdens on the plaintiff is appropriate is the arguable original under-

113. This is an elusive problem, caused by the fact that when a disclosed soft datum, for example, a projection, fails to eventuate, it may be perceived as either (a) an untrue statement when made but excusable if made in good faith and with a reasonable basis, or (b) a statement true when made if in good faith and with reasonable basis. The difficulty is that §§ 11 and 12(2) of the 1933 Act, 15 U.S.C. §§ 77k, 77l(2) (1976), both impose a duty of diligence or care on a defendant. Section 11 imposes liability where any part of the registration statement contained an untrue statement or omitted a material fact but imposes certain burdens of proving due diligence on the potential defendants other than the issuer, who has no such defense. For example, for non-expertised portions of the registration statement, the non-expert defendant must show that "he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part became effective, that the statements therein were true and there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Id. § 77k. Section 12(2) similarly imposes a burden on the defendant.

This being so, it could be urged that it would be inappropriate for a court to require a plaintiff under either of these sections first to prove that the defendant had no good faith or reasonable basis, since the defendant would then have no burden of proof, contrary to the statute. However, both statutory sections do require that there be an untrue statement or omission, and the cases previously discussed all state or assume that a projection is not an untrue statement when made merely because it fails to eventuate.

See generally 2 Bromberg, supra note 66, § 6.5(454), at 136.167-.168; Mann, supra note 4, at 239. Bromberg states that if the SEC purports to adopt a safe harbor rule to impose the burden on the plaintiff, this could be beyond its power if the statutes are construed as imposing the burden on defendants. But he then also suggests that under § 19(a) of the 1933 Act, 15 U.S.C. § 77s(a) (1976), and § 23(a) of the 1934 Act, id. § 78w(a), a defendant who relies on the invalid SEC rule is nevertheless protected.

I disagree with this last conclusion, since it would seem that there can be no real reliance on a rule concerning burden of proof. To cause the suggested effect, the statute would have to read something like, "even an invalid SEC rule must be observed by the court." In any event, I am convinced that none of these questions should be raised because the first question is whether there has been a misrepresentation, and the plaintiff must prove that.

114. Regulation S-X, § 3-17(g), 17 C.F.R. § 210.3-17(g) (1977).
116. REPORT, supra note 3, at 364.
117. In its proposed safe harbor for projections, the SEC suggested that the defendant should have a defense. Sec. Act Release No. 5696, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,406. See also Dolgow v. Anderson, 53 F.R.D. 664, 668 (E.D.N.Y. 1971), aff'd per curiam, 464 F.2d 437 (2d Cir. 1972) (defendant, apparently out of an excess of caution, felt constrained to undertake the burden of proving good faith, reasonable basis, and appropriate qualifications).
standing of Congress, when the 1933 Securities Act was enacted, that disclosure was to be aimed at sophisticated investment bankers who could be expected to interpret and filter the data for laymen. Because sophisticates can understand the limitations on soft information, the burdens of pleading, going forward with the evidence, and persuasion should be on the person claiming misrepresentation.

3. Justifiability of the Plaintiff's Reliance on Soft Information

The inherent unreliability of soft information undoubtedly will make it somewhat more difficult for plaintiffs to recover in actions which require reliance as an element. Some decisions which are expressly based on immateriality or on the conclusion that an "opinion" and not a "fact" was involved perhaps could be analyzed more clearly as cases in which the particular plaintiff's reliance was unjustified. For example, a statement that next year's profits are expected to exceed those of the current year, when made with the slightest qualifications with respect to a company having a volatile earnings history, is unlikely to be relied upon by the particular plaintiff.

B. Problems of the Co-relationship of Two or More Items of Data When Only One of the Items is Published

When two or more bits of data have relevance to a company's

118. See notes 32-39 & accompanying text supra.

119. Prices will adjust for available information as interpreted by sophisticates according to the efficient market empirical studies. Hence the market is a surrogate for the unsophisticated who cannot overpay or sell at too low a price.

Professor Douglas said it all when he stated:

Even though an investor has neither the time, money, or intelligence to assimilate the mass of information in the registration statement, there will be those who can and who will do so, whenever there is a broad market. The judgment of those experts will be reflected in the market price.

Douglas, supra note 38, at 524.


121. The relationship between "materiality" and "reliance" is said to be this: While materiality depends on whether the reasonable mind considers the datum important in the decision-making process, reliance involves the question whether the particular plaintiff considered it important. List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965).

Professor Prosser states:

It is more correct to say, therefore, that a statement of opinion is a representation of a fact, but of an immaterial fact, on which the law will not permit the opposing party to rely. When, for any reason, such reliance is regarded as reasonable and permissible, a misstatement of opinion may be a sufficient basis for relief.

W. PROSSER, supra note 91, § 109, at 721 (footnotes omitted).
prospects and only one of the bits is published, several difficult questions arise because of their co-relationship. The first such question already has been mentioned: the half-truth involving a failure to qualify a statement made in order to make it not misleading.122 The second is what might be termed the spurious half-truth, involving two unrelated data, one "good" and the other "bad." The third is the problem of a published datum which is meaningless (but not otherwise misleading) unless placed in context by disclosure of background data.

1. Half-Truths; Spurious and Legitimate

One technique for dealing with soft data is to apply the half-truth concept liberally: a partial statement of the facts which omits crucial qualifying information constitutes a misrepresentation.123

In certain situations, such as in proxy solicitations, tender offers, or redemptions, disclosure of material information clearly must be made regardless of the relationships among the individual data. Thus, to illustrate with two items of hard data, loss of a major customer and an ore discovery must both be disclosed, if material. But assume that instead of a proxy statement, the issuer merely publishes a press release to describe a major ore discovery. Must the press release include all news about the company of a material nature, including the loss of the major customer?

It might be thought that any disclosure which contains a datum relevant to investors' needs is a half-truth unless it contains all the material information known. Hence, it may be urged that the press release concerning the material ore discovery should also disclose the customer loss. However, if the half-truth concept were applied indiscriminately in this situation, any press release would have to be prepared similarly to a 1933 Act prospectus—a costly requirement which surely would halt the flow of all information. Moreover, investors do not expect press releases to be so complete. Because of the unwieldiness of requiring full disclosure of all data when a single datum is disclosed and because investors do not expect such disclosure, courts should not apply the half-truth concept to its fullest logical extent here. Rather, if disclosure of the customer loss is required, it should be required on some basis other than the simplistic half-truth concept.124 On the other

122. See notes 102-03 & accompanying text supra.
124. For earlier, milder criticisms of over-use of the half-truth concept, see Schnei-
hand, all material data relating to the ore discovery should be disclosed to avoid a genuine half-truth.

This problem is slightly more complex when one of the data is related soft information. It is failure to disclose an earnings projection for 1978 simultaneously with an earnings statement for 1977 a spurious half-truth only, so that a court should not find a misrepresentation? A different result would break with tradition; courts have never required the disclosure of an existing forecast in order to avoid a half-truth through publication of historical financial statements.

One explanation for this result is that traditionally, as we have seen, projections were prohibited in SEC filings and were once even considered misleading per se.125 Under these circumstances, a failure to disclose a projection hardly could be actionable.126 But, if the Advisory Committee's recommendations are adopted, the historical basis for the exclusion of soft data from the disclosure scheme should be irrelevant. Indeed, projections already are permitted. Nevertheless, in a recent case, the court declined to break with tradition, holding that a forecast need not be disclosed in a prospectus.127 However, the court did hold that the prospectus must disclose the underlying primary data which could form the basis for an investor's determination that the prior earnings trend would not continue.128 That being so, one may expect that, at least for firms with reliable forecasting experience, it may not be long before the courts recognize true half-truth situations. Initially, many courts probably will treat the SEC's permissive view at face value; permitting but not mandating the disclosure of soft information. But, as time passes, the logic of the half-truth may well take hold and cause courts to require full disclosure of the penumbral data.

Here we see the first indication of a possibility that when soft data is no longer prohibited, instead of merely becoming permissive, it becomes mandatory by virtue of the operation of the anti-fraud rules. This can become a powerful concept. Since most hard data is surrounded by a penumbra of soft information, which

125. See notes 40, 77-82 & accompanying text supra.
128. Id. at 93,339.
traditionally, at least in part, has been undisclosed, a vast new area of mandatory disclosure may open up. We shall return again to this theme.\textsuperscript{129}

2. Data Which Are Meaningless Without Additional Related Information

Another difficult problem is the case of a published, unevaluated datum which, in isolation, may be meaningless to investors.\textsuperscript{130} The \textit{Texas Gulf Sulphur} opinion\textsuperscript{131} obliquely addresses this situation in dicta as an introduction to its section on what constitutes material inside information required to be disclosed by an insider who is trading.\textsuperscript{132} The \textit{Texas Gulf Sulphur} court clearly intended that only materially important basic facts need to be disclosed; there is no additional duty to disclose the insider's evaluation of the data based on what may be termed background data concerning the company or on superior analytical skills.

But does the \textit{issuer}, as opposed to the insider, have an independent duty to provide background data or an evaluation of the otherwise meaningless data? The concept of the half-truth described in the preceding section (involving related data one of which is good and the other bad) may apply, at least for background data, where one datum is in itself meaningless but would become good or bad with the additional information.

Moreover, once soft information becomes of kin to hard data, can the \textit{Texas Gulf Sulphur} dictum\textsuperscript{133} continue to protect insiders who are able to interpret otherwise meaningless data solely because of their access to inside soft information, that is, background

\textsuperscript{129} See notes 171-93 & accompanying text infra.

\textsuperscript{130} Again, we are concerned here with press releases or other isolated disclosures, not proxy solicitations or other situations where comprehensive disclosure is required.


\textsuperscript{132} An insider is not, of course, always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors. An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in "those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation is] disclosed."

Nor is an insider obligated to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions. The only regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders.

\textit{Id.} at 848-49 (emphasis added) (citations omitted).

\textsuperscript{133} See note 132 & accompanying text supra.
data? Should the insider’s fiduciary duty continue to be less for soft data once such data are equated with hard? And, is the insider’s trading in this situation any less unfair than when he has inside hard data?

On the other hand, the Texas Gulf Sulphur dictum with respect to generally available information, that is, not including background data, is consistent with the emerging view that disclosure should be for the sophisticate. A sophisticated person can evaluate the data for himself and at his own cost, not only in terms of payments made to compile the data but also in terms of the costs of coming to the wrong conclusion.

Nevertheless, as suggested above, for truly inside background data, we might expect that courts will require disclosure of certain data to allow a reasonable basis for investors to evaluate the material data which are disclosed. Even in Texas Gulf Sulphur, although the company was not required to provide an education in geology, it was required to provide additional data so that investors could view the full picture. Here the half-truth concept does seem to apply legitimately to impose upon issuers and perhaps insiders and their tippees a duty to disclose the relevant soft data.

C. Insider Trading on and Tipping of Soft Information

1. Soft Information as Inside Information—“Ripeness” and “Materiality.”

The classification of inside information as hard or soft does not alter the broad outlines of the conceptual analysis of when an insider who trades or tips others who trade has a duty to disclose.

Most soft information is inside information; that is, soft information is largely undisclosed and originates within the firm. Further, because much of it is highly material, for example, projections and asset appraisals, it is surprising that insiders are allowed to trade at all. The wonder of it all becomes even

134. Plans and proposals are also material items of soft data. As noted, disclosure of plans and proposals is required in registered tender offers, showing that they are material in the view of Congress. See note 7 supra. Although this, of course, does not make them material for all purposes, it is highly persuasive. Plans to liquidate were also considered material in proxy and insider trading cases. See Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973); Speed v. Transamerica Corp., 99 F. Supp. 808, 843 (D. Del. 1951), modified and aff’d, 235 F.2d 369 (3d Cir. 1956). In Nelson v. Serwold, 576 F.2d 1332 (9th Cir. 1978), petition for cert. filed, 47 U.S.L.W. 3159 (U.S. Sept. 19, 1978) (No. 78-182), a plan to build the company into a marketable entity was held required to be disclosed by an insider-purchaser. See generally 2 Bromberg, supra note 66, § 6.5(214), at 134.27.

135. Of course, when soft information such as an appraisal is prohibited in formal disclosure documents, it would seem harsh to impose insider trading liability for failure to disclose informally. See Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951), modified and aff’d, 235 F.2d 369 (3d Cir. 1956) (side stepping the issue).
greater when one superimposes the SEC's recently expressed view that an insider who trades while in possession of material inside information violates rule 10b-5, even if his trade is not motivated by the particular inside data. Since insider trading restrictions apply equally to issuers who buy or sell their own or an affiliate's securities, it follows that soft information, if material, must be disclosed in issuer tender offers or other redemptions just as if it were hard information.

a. The Issue of Ripeness—or Unreliability. The nature of 

But since the insider's alternative is simply not to trade, the dilemma of the issuer prohibited from filing soft data is absent. Cf. Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973) (proxy case).

The view has been expressed that an issuer (which may have a higher duty than other "insiders") may have a duty to refrain from purchasing its own shares if it has made internal projections, see P.L.I. FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 17 (1974), at least when the projections are off the trend or would "surprise" the market. Id. at 18-19.

Even outside the federal securities laws, there is a significant body of state law to the effect that there is a fiduciary obligation of insiders (including the issuer) to disclose material information to persons who sell their stock to the insider, at least when there are "special circumstances." Strong v. Repide, 213 U.S. 419 (1909) (Philippine law); Lank v. Steiner, 43 Del. Ch. 262, 224 A.2d 242 (1966). Some courts do not even require special circumstances. See Hotchkiss v. Fisher, 136 Kan. 530, 16 P.2d 531 (1932); W. CARY, CASES AND MATERIALS ON CORPORATIONS 583-86 (4th abr. ed. 1970).

Last year the Delaware Supreme Court held that a controlling parent corporation making a tender offer for the minority shares had an affirmative duty to disclose material information which, in that case, was an appraisal of the value of the subsidiary's net assets—a classical form of soft information. Lynch v. Vickers Energy Corp., 383 A.2d 278 (Del. 1977). The court held that the parent owed a duty of "complete candor" and that all information in its possession "germane" to the tender offer must be disclosed. "Germaine" was defined to mean "information such as a reasonable shareholder would consider important in deciding whether to sell or retain stock. Compare TSC Industries, Inc. v. Northway, Inc., [426 U.S. 438 (1976)]." Id. at 281.

In Lynch, the offeror disclosed that the net asset value of the company, an oil and gas development firm, was "not less than $200,000,000 (approximately $16.00 per share) and could be substantially greater," id. at 280 (emphasis in original), but failed to disclose an item of soft information, an estimate by a vice-president of the company with special expertise in petroleum engineering fixing the value at $250.8 million (or $20 per share) to $300 million (or $24 per share).

The court not only did not seem to require "special circumstances" but also held that there was a breach in fact. That court's earlier opinion in Lank v. Steiner had stated the "special circumstances" rule but failed to find any such circumstances, holding for defendant. Thus, Lynch is especially significant.

It should be noted that, in both cases, there was a direct purchase and sale between the defendant, as seller, and plaintiff, as purchaser. The opinions may not apply to stock exchange transactions, see Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933), and may not apply to sales by a defendant, since the seller may not be deemed a fiduciary of the buyer until after the sale. See In re Cady, Roberts, & Co., 40 S.E.C. 907, 913-14 & n.23 (1961).

137. Eg., Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1972) (en banc).
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soft data is such that much of it is simply not ripe for disclosure. In some cases it will be so infirm as not to be reliable; for example, a sales manager may be in possession of knowledge of an increase in the size of orders from several major customers but have no further knowledge of the cause. Because of the unreliability of this data, he should not be held liable for trading profits or tipping others who profit. On the other hand, the court considered the first drill hole in Texas Gulf Sulphur\(^\text{138}\) sufficiently material to require disclosure before trading, even though its promise might not have been borne out.\(^\text{139}\) Of course, the soft information may become outdated before it can be disclosed.\(^\text{140}\)

A fertile source of authority for an insider's duty to disclose soft data is the tender offer cases. Although disclosure is expressly required by the tender offer rules,\(^\text{141}\) the theory is the same as for insider trading: material facts must be disclosed to shareholders who are invited to make tenders of their shares.

But softness is special, and it presents special problems. The very trait which distinguishes soft information from hard is its unreliability, that is, "softness." Here too, the tension between the low degree of reliability and the high degree of materiality of much soft data suggests certain differences in the law of insider's trading and tipping for hard and soft inside information.

In the tender offer area, the question is phrased in terms of materiality, but the factors for consideration are much more complex than a determination of what is important to investors. These factors concern what I have described as "ripeness," or the unreliability of soft information.\(^\text{142}\)

In addressing this question of ripeness, the court should consider the specific circumstances of the case, balancing the advan-

\(^{138}\) 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

\(^{139}\) Recall that the trial court in Texas Gulf Sulphur held the first hole not "material" on the basis that one drill hole does not show the volume of the mineralization, which would require at least three holes. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 282-84 (S.D.N.Y. 1966), rev'd, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). The trial judge thus had a different taste for ripeness.

\(^{140}\) If the soft information is disclosed but does not eventuate in fact, liability for misrepresentation may ensue if there was no reasonable basis for the datum. See text accompanying notes 77-119 supra.


\(^{142}\) Bromberg suggests that materiality and ripeness are "corollary" to the affirmative duty to disclose. 2 Bromberg, supra note 66, § 8.2, at 198 n.9.
tages and disadvantages of non-disclosure and of outlawing the insider's transaction. For example, a court should take into account the SEC regulations, the degree of hardness, the insider's consciousness of the data, the unfairness of penalizing the insider if his opinion turns out wrong, the possibility that disclosure of the soft data may in fact harm investors, and the facility with which the data appropriately may be disclosed and qualified.

This approach was used in *Alaska Interstate Co. v. McMillian* to determine a tender offeror's duty to disclose certain soft information consisting of appraisals of oil and gas reserves and a rough budget including forecasts of capital expenditures, non-cash items, and debt repayment schedules. These data, prepared by the target management for internal purposes, were never intended for publication. Clearly, the court viewed the problem as one of balancing the relative unreliability of the soft data against its materiality:

This Court [has] recognized . . . that no hard and fast rule could be drawn about "soft information". The distinction between soft information which must be disclosed and that which need not be was recognized as "one of degree", with determination of those categories to rest upon such factors as the importance of the information, the amount of subjective judgment which the information reflects, and the practical difficulties in fashioning a disclosure which would not create "more potential for misunderstanding than enlightenment."

The *Alaska Interstate* court then made it very clear that it was

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144. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448 (1976). The Court noted, "Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good." *Id.* See also *Denison Mines Ltd. v. Fibreboard Corp.*, 388 F. Supp. 812, 821 (D. Del. 1974).
145. The court recognized unreliability as an important concern:

This Court has recently had occasion to discuss the dangers inherent in the disclosure of so-called "soft" corporate information. [We] relied in particular on the Third Circuit's statement . . . of the "general rule" that "presentations of future earnings, appraised asset evaluations and other hypothetical data in proxy materials" was to be discouraged.

*Id.* at 567 (citations omitted).
146. *Id.* The court then juxtaposed two insider trading cases, *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974), and *SEC v. Lum's, Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973), with the facts in the case before it, stating that in the *Shapiro* and *Lum's* cases the soft data was less soft. In those two cases the soft information which was selectively disclosed to tippees consisted of short range earnings forecasts for the current quarter in one case and the current year in the other (both also revealed a substantial departure from the trend and were thus material).
weighing reliability against materiality when it stated: "Accordingly, while the forecasts [in Shapiro and Lum's] involved some prediction, their reliability was not a factor of substantial significance, and the importance of the information to investors far outweighed any potential for misunderstanding."\textsuperscript{149}

The balancing process used by the court in \textit{Alaska Interstate} is a sensible method by which to determine ripeness for publication of soft data. Moreover, given the evolving attitude toward the use of soft data, perhaps the general policy of discouraging its publication should be reevaluated.

b. \textit{An Alternative: Materiality and the Market Price Impact Test}. One alternative to this balancing approach that restricts the duty to disclose because of the unreliability of the data does so by raising the standard of materiality. Instead of applying the \textit{TSC Industries}\textsuperscript{150} standard of importance to investors, together with the \textit{Alaska Interstate}\textsuperscript{151} balancing process described above, it defines materiality in terms of the likelihood that the undisclosed datum will have a substantial impact on market price of the securities.\textsuperscript{152}

In the most significant case involving insider tipping of soft information since \textit{TSC Industries}, the court apparently endorsed this more stringent test. \textit{SEC v. Bausch \& Lomb, Inc.}\textsuperscript{153} held that the selective disclosure to an analyst of an earnings forecast was a tip of material information, while a disclosure that the introduction of two new products would be delayed was not material. But, interestingly, the court, in expressly referring to the \textit{TSC Industries} definition, seemingly equated materiality with the market impact test. Thus,

\begin{itemize}
  \item \textsuperscript{149} 402 F. Supp. at 567 (footnote omitted).
  \item \textsuperscript{150} 426 U.S. 438 (1976).
  \item \textsuperscript{151} 402 F. Supp. 532 (D. Del. 1975).
  \item \textsuperscript{152} See, e.g., \textit{In re Investors Management Co.}, 44 S.E.C. 633 (1971); \textit{In re Merrill Lynch, Pierce, Fenner & Smith, Inc.}, 43 S.E.C. 933, 937 (1968).
  \item \textsuperscript{153} 565 F.2d 8 (2d Cir. 1977).
  \item \textsuperscript{154} \textit{Id.} at 14-15 (citations omitted). The court cited \textit{SEC v. Texas Gulf Sulphur Co.}, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), \textit{cert. denied}, 394 U.S. 976 (1969), which had stated the market price impact test and quoted the test in \textit{TSC Industries}. In \textit{Arber v. Essex Wire Corp.}, 490 F.2d 414 (6th Cir.), \textit{cert. denied}, 419 U.S. 830 (1974), the court viewed that test as being different from the importance-to-the-rea-
The market impact test makes sense for publicly traded securities—*nothing else that also ought to be protected by the securities laws* would matter to investors. Even if, for example, many investors would like to know data relating to a pending merger with a defense contractor because they would prefer not to be involved with certain weaponry, if the price of their shares is not affected, they may sell them and invest in non-defense manufacturers.\(^{155}\)

For publicly traded securities, the market impact test also has the merit of protecting insiders from liability in cases where they could not profit monetarily—if there is no impact on price, they cannot benefit. Finally, the test is consistent with an important function of the materiality standard—the limiting function—which has been ignored too long.\(^{156}\) Just as the materiality standard for admissibility of evidence at a trial limits the introduction of evidence in order to provide a balance of the costs and benefits, so too, materiality for securities law disclosure limits the cost of preparation and processing of disclosure statements.\(^{157}\)

sonable-investor test and repudiated the former. *Id.* at 418. Although the corporation there was closely held, the court's opinion did not turn on this fact as it might have. In a close corporation, the price of the shares will often not reflect intrinsic value because of lack of an efficient market, and hence price will not be an assimilation of (and therefore not a surrogate for) all material data.

155. Income tax consequences might accrue if they sell. But since they are not compelled to sell, this may be a legitimate cost of their desire to avoid investing in weapons manufacturing.


*Material.* The term “material,” when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered. *Id.* § 230.405(1).

157. The view that disclosure should be for sophisticates only will also be relevant in limiting disclosures under this materiality test. For example, in SEC v. National Sec., Inc., 393 U.S. 453 (1969), a takeover was to be followed by a merger. Must the offeror also state that the merger would enable use of the target company's assets to pay off the loan used for the takeover? The Supreme Court intimated that would be material, but Bromberg properly points out that any sophisticate would note this as an obvious consequence of the merger. 1 *Bromberg, supra* note 66, § 6.3(462), at 118.9 (citing Electronics Specialty Co. v. International Controls Corp., [1967-1969 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,323, at 97,527 (S.D.N.Y. 1968), where the court did not think the bootstrap possibility material).

*See also* Symington Wayne Corp. v. Dresser Indus., Inc., 383 F.2d 840 (2d Cir. 1967) (holding that no disclosure of the difference in taxability of a merger and a sale of assets was required since investors are expected to know of the difference).
2. Selective Disclosure

Three concepts of selective disclosure, when analyzed together, pose difficult problems for courts seeking to ascertain the parameters of the duty to disclose soft information truthfully. We have seen that it may still be good law that a published datum, meaningless or ambiguous without further evaluation, need not be evaluated by a trading insider applying his knowledge for the benefit of the outside buyer or seller where that knowledge is not company-originated inside information.\footnote{158} In this situation the primary datum may have to be disclosed but need not be explained before an insider may trade on the basis of his own evaluation of that datum.

There is another principle, observed in formal disclosure contexts, for example, a proxy statement, to the effect that individual bits of immaterial data, which in the aggregate become material, must be considered material and be disclosed.\footnote{159}

At the same time, it has been asserted that an insider may with impunity tip others as to information which is not independently material and which the tippee may weave into the matrix of knowledge obtained elsewhere. Indeed, in \textit{SEC v. Bausch \\& Lomb, Inc.},\footnote{160} the Second Circuit noted in dicta that corporate issuers are “[e]xhorted by the Securities and Exchange Commission and the various stock exchanges to divulge tidbits of non-public, ‘non-material’ information” to the inquiring analyst.\footnote{161} This “mosaic theory”\footnote{162} has been outlined in the following manner:

As commonly stated, the mosaic theory asserts there are two types of information:

1. Information which, standing alone, has importance.

2. Information which, standing alone, has no importance but assumes importance when considered in light of the grand mo-

\footnote{158. See notes 130-32 & accompanying text \textit{supra}.} \footnote{159. See 2 BROMBERG, \textit{supra} note 66, §§ 6.5(414)(25), (426).} \footnote{160. 565 F.2d 8 (2d Cir. 1977).} \footnote{161. \textit{Id.} at 9. The court supported its assertion with the following:\footnote{See e.g., New York Stock Exchange Company Manual (July 18, 1968); Address by Phillip A. Loomis, Jr., General Counsel, SEC, “Corporate Disclosure and Inside Information”, Financial Analysts Federation, October 7, 1968; Address by Richard B. Smith, Commissioner of the SEC, “Corporate Disclosures to Security Analysts”, Graduate School of Business, The University of Chicago, May 8, 1969; Address by Ray Garrett, Jr., Chairman of the SEC, “The Role of Financial Public Relations”, Chicago Publicity Club, March 13, 1974. \textit{Cf.} Guidelines for the Release of Information by Issuers Whose Securities are in Registration, Securities Act of 1933 Release No. 5180 (August 16, 1971).} \textit{Id.} at 9 n.1.} \footnote{162. As pieces of a mosaic are meaningless until put in place by one who makes the design, so too are some data immaterial except to one who has additional knowledge, skills, or data.}
saic of other information about the company . . . . The impli-
cation of the mosaic theory is that [the second class of items]
can be [given to or] obtained [by tippees] without fear of legal
liability.\textsuperscript{163}

Is the mosaic theory consistent with the aggregate materiality
concept and the principle that a trading insider need not publish
his own evaluation of disclosed data?

The three concepts may be rationalized as follows. It may be
urged that the aggregate materiality concept, holding that several
immaterial items may become material in the aggregate, applies to
\textit{formal} disclosure documents where \textit{all} material information must
be disclosed, and that these are documents intended to be com-
plete within their own confines. In contrast, the insider evaluation
and mosaic theory concepts are concerned with the \textit{informal} dis-
closure required when an insider trades or tips. Even though the
insider must disclose all material inside information before trad-
ing or tipping, this means all previously undisclosed \textit{material}
information. Thus, consistent with the mosaic theory, he need not
publicly disclose an immaterial bit of information.

On the other hand, if that bit becomes material when aggre-
gated with another bit of public information, by itself immaterial,
then the insider presumably must disclose. Thus, the mosaic the-
ory should not permit tipping of a bit of data which becomes ma-
terial in the light of previously disclosed data. Yet, this is the very
heart of the mosaic theory; it is believed acceptable to tip an ana-
lyst with an individually immaterial datum which he can aggre-
gate with other data to establish a material fact. The mosaic
theory, therefore, is inconsistent with the aggregate materiality
concept unless it is limited to formal disclosure.

Similarly, the insider's freedom to evaluate disclosed data,
without disclosure of his evaluation, presupposes that all primary
data have been made public, contrary to the mosaic theory, which
involves tipping an analyst without informing all the public.
Hence, the mosaic theory is not merely a special case of an in-
insider's freedom to retain his own evaluation before trading or tip-
ing.

But the mosaic theory arguably is grounded in a legitimate
public policy: because analysts serve the useful function of ferret-
ing out information for many firms,\textsuperscript{164} the analyst must be al-
lowed to obtain and use "tidbits."\textsuperscript{165} It is argued that the purpose

\textsuperscript{163} Beaver, \textit{supra} note 155, at 50.
\textsuperscript{164} This is true for only about 1,000 publicly held firms. \textit{REPORT}, \textit{supra} note 3, at
XXIII. The rest of the 10,000-odd public companies have no serious analyst follow-
ing. \textit{Id.} at 39.
\textsuperscript{165} Kripke, \textit{An Unusual Opportunity for Rethinking Concepts on a Fundamental
of the mosaic theory is to facilitate the flow of information among advisors to investors. However, Beaver suggests that selective disclosure to a few advisors restricts competition in evaluating the data since not all advisors have the selectively disclosed item. Moreover, what is material to one analyst may be material to another; hence the mosaic theory violates the policy of the securities laws that equal access to information be available to all. He concludes that the merit of the mosaic theory is not self-evident. Arguably it proves too much. It is little different from saying that the analyst ought to be allowed to be given any—even independently material—inside information which would further encourage the analyst to serve this ferreting function. It seems that Beaver is correct: information which is material to the analyst is material to the public, and the mosaic theory rests on a precarious footing.

All that has been said so far about the mosaic theory applies equally to hard and soft data. The special problem with soft data, however, is that much of it is immaterial by itself; therefore, it is a prime candidate for application of the mosaic theory. If the theory is wrongly followed by the courts, much abuse could result.

Another special problem is associated with soft information. As noted previously, the issuer commonly provides the placee with projections in private placements. Is this illegal tipping? There is no doubt on the question if the placees also trade. But what of the shares privately placed, assuming a primary offering? It can be said that they were purchased on the basis of inside information. In Texas Gulf Sulphur, where certain individuals received stock options while in possession of inside information not known to the stock option-granting committee, the court found a violation of rule 10b-5. But even where the board knows of the information, the private placee's purchase dilutes the interests of other shareholders. And, certainly, if the private placement were motivated by a desire to grant an advantage to the placees rather than by the issuer's need for funds, the transaction should be illegal.

(suggesting that limiting the analyst in his search for information may lead to a less efficient market).

166. Beaver, supra note 155, at 51. Beaver also suggests consideration of various cost-benefit issues. Id.

167. This result would be reminiscent of the view of Henry Manne that insiders should themselves be able to trade on inside information. H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966).

168. See note 82 supra.


D. Special Problems of Soft Information When There is an Affirmative Duty to Disclose

Although it is by no means settled, under rule 10b-5, when an issuer's securities are being traded in some market, the issuer may have an affirmative duty to disclose material information even if the issuer and its insiders are not trading, tipping, or otherwise recommending trades.\(^{171}\) Presumably, based on principles of vicarious liability developed under rule 10b-5, certain participants in the breach of duty also may be held vicariously liable for the issuer's breach on a theory of aiding and abetting, conspiracy, or otherwise.\(^{172}\) The case authority is rather inconclusive, because no case squarely imposes liability on this basis. Rather, the courts have skirted the main problem, finding limitations on the duty without deciding whether one exists. Thus it seems to be generally accepted, if not settled, that when the issuer has a valid business purpose for non-disclosure of a datum material to investors, that datum need not be disclosed even if non-disclosure may result in injury to investors.\(^{173}\)

Additionally, it is probable that, even absent such judgment of the corporate managers, if information is not "ripe" for disclosure because it is still uncertain, no duty exists.\(^{174}\) "Ripeness" means that the data "must be verified sufficiently to permit the [management] . . . to have full confidence in their accuracy."\(^{175}\)

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171. See, e.g., 5A A. Jacobs, The Impact of Rule 10b-5, § 88.04 (rev. ed. 1977). It was probably not contemplated that an issuer should have the right to maintain silence forever concerning material facts, and to the extent that periodic reporting requirements do not apply, the only legal basis for disclosure would be one of the anti-fraud rules. One policy basis for imposing an affirmative duty to disclose is that insider trading is common; and if the rules against such trading without disclosure are to work in fact, the issuer, not the insiders, must undertake a regular disclosure program. Another basis for imposing the duty is that rumors frequently circulate, and without issuer disclosure there is likely to be misinformation amounting to misrepresentation whenever anyone trades.

172. See 3 Bromberg, supra note 66, §§ 8.5(500)-(540); 5 A. Jacobs, supra note 171, § 40.02-.04.


175. Id. at 519. The Tenth Circuit also includes in the ripeness test the question whether there is a business purpose for non-disclosure. The reason for the ripeness requirement, according to this opinion, is "the hazards which arise from an erroneous statement," presumably the danger of deception to investors. Id. at 519. This is akin to what we have already seen was one reason why soft information once was altogether prohibited in formal filings.

The opinion predates the later stages of the soft information revolution. It could be read as merely holding that soft information need not be disclosed until "verified sufficiently." In this sense, soft information is never ripe. If that is the reading of the
Prudent corporate legal advisors probably should assume that issuers have an affirmative duty to disclose under rule 10b-5. For issuers which have shares listed on a stock exchange, the rules of that exchange may eliminate any doubts by imposing the duty expressly.

When projections and other soft data were prohibited from formal SEC disclosure documents, although not from informal publication, it was probably safe to withheld that soft data. A complainant hardly could urge that a projection prohibited in formal documents was mandated in an informal publication, and the absence of decisions on point is probably due to the fact that no plaintiff has had the effrontery to urge the matter seriously.

However, now that projections and other soft data are permitted, or mandated, in formal documents, and if they are to be "encouraged" in accordance with the Report, the independent affirmative duty to disclose, as suggested above, may operate to mandate disclosure of material soft information just as it would mandate material hard data.

Nevertheless, even if an affirmative duty to disclose exists, the unique characteristics of soft information require management to engage in a special analysis to determine the need to disclose a specific datum. This analysis often may reveal a valid business purpose for non-disclosure of certain soft information. To illustrate, a plan to initiate a fifth generation computer, if disclosed too early, could inhibit sales of the fourth generation stock. Doubt-case, it has not been followed, and the case is of no precedential value outside the Tenth Circuit, where it would be weak authority. However, the case has not been so interpreted.

176. That is to say, one may not safely assume that there is no such duty.
177. E.g., N.Y. STOCK EXCHANGE COMPANY MANUAL 4-18 (1977). Of course, the remedies for the breach of duty to observe a stock exchange rule of disclosure may not include all the same remedies available under rule 10b-5 generally. See R. JENNINGS & H. MARSH, supra note 89, at 889-91.
178. See notes 77-82 & accompanying text supra.
179. If formal disclosure is prohibited by the SEC, a good defense to a failure to disclose soft data in formal documents may be established. The SEC's practice of banning appraisals has been held to be a defense to an action for failure to disclose such appraisals in proxy materials. Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1294 (2d Cir. 1973).
180. See note 7 supra.
181. Id.
182. See note 31 supra.
183. See text accompanying notes 128-29 supra.
185. This discussion is not concerned with any potential claims a purchaser of a fourth generation computer might have. We are concerned here with securities investors.
less, many questions will arise as to what constitutes a valid business purpose. For example, is it a valid business purpose for an issuer to withhold information pertaining to a planned takeover when disclosure would diminish the possibility of success?

In addition, no disclosure is required when, in the business judgment of management, the datum is not yet “ripe.” Since, by definition, soft information is subjective or future-looking, and not objectively verifiable, it frequently may be unripe. In the most important case on the affirmative duty to disclose, Financial Industrial Fund, the court found no breach of the duty; because, in the judgment of management, the soft data were too unripe for disclosure. The data, a six-month earnings statement showing a decline, was published after plaintiff had purchased shares in the market. The court concluded that the defendant had sought diligently to calculate the estimated earnings and had published them on the day following its evening determination, in effect finding the information not ripe before that time.

Even the court in Texas Gulf Sulphur touched on the subject, stating that materiality “will depend at any given time upon a balancing of both the indicated probability that the event _will occur_ and the anticipated magnitude of the event in the light of the totality of the company activity.” Moreover, in Richardson v. White, Weld & Co., a failure to disclose a corporation’s views on the anticipated results of a massive lobbying campaign to deregulate natural gas was held not actionable on the basis that the

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186. Even in the case posed, the ethical questionable of not informing fourth generation computer purchasers may raise a question of the validity of the business purpose. _But cf._ SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 (2d Cir. 1968) (en banc), _cert. denied_, 394 U.S. 976 (1969); Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333, 1338-39 (S.D.N.Y. 1969) (purpose of concealing the ore strike from landowners in order to facilitate land acquisition was held a valid business purpose). The perennial business reason for any non-disclosure has been that disclosure would hinder competition. Presumably, the courts will require more than just the assertion of this reason as an excuse.

187. Consider the treatment of contingent liabilities not probable of assertion when an auditor requests such information from a lawyer. If the liability is not probable of assertion, it need not be disclosed. The business purpose of non-disclosure is largely to avoid triggering assertion by the potential claimant. A putative investor would like to know of such contingent liabilities, but the practice sanctioned by the ABA is not to make the disclosure to the auditor, thereby avoiding disclosure to investors. _See_ American Bar Association, _Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information_, 31 Bus. Law. 1709, 1712 (1976).


189. Indeed, if “ripe” means objectively verifiable, as is intimated in _Financial Industrial Fund_, soft information by definition may never be ripe. _See_ notes 3, 175 supra.

190. 474 F.2d 514 (10th Cir.), _cert. denied_, 414 U.S. 874 (1973).

191. 401 F.2d at 849 (emphasis added).

data were not material, although the more precise basis seems to be lack of ripeness.

It thus appears that if there is an affirmative duty to disclose material information, soft data are less likely to be required than hard data, because soft information, by its very nature, is often unreliable and hence not ripe for disclosure.

E. Duty to Update, Correct, or Disaffirm—“Staleness”

Although the very “softness” of soft information may frequently excuse an issuer from an affirmative duty to disclose, this same softness usually will result in soft data, such as a projection, forecast, or appraisal which is published, not being perfectly on target, thereby raising additional problems for issuers. If the soft datum fails to eventuate precisely as stated, there will be the question whether some duty to update, correct, or disaffirm arises.

The basic issues underlying most of these problems are whether, under the circumstances, investors may be misled by the uncorrected original statement and whether the pecuniary and nonpecuniary costs of revising the data would be excessive.


What looks to one court like a question of a duty to correct may appear to another to be an affirmative duty to disclose. Consider Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir.), cert. denied, 414 U.S. 874 (1973), which, as we have seen, was considered to be in the latter category. In the trial court, however, instead of being considered a case involving the affirmative duty to disclose six months' earnings, it was viewed as a question of the duty to correct a five months' statement. [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,004 (D. Colo. 1971).
For example, by the time the question arises, the data may be stale and therefore may not require additional disclosure. If an acquiring company issues a release indicating its plans to merge and, subsequently, liquidate a large segment of the acquired company, but then cancels the merger and reports to a financial newspaper news of this cancellation, there can be no duty to correct the statement concerning liquidation: most investors will have access to the information, while additional disclosure would be costly. However, one may expect that, generally, forward-looking soft data will have a continuing vitality and a longer self-life than hard data. Thus, the hard datum of 1977 earnings need not be updated, but a projection for 1978 may require current revisions until 1978 final data are published.

Of course, if a stranger on whom the market has no reason to rely prepares a projection, the issuer will not endorse its contents and, perhaps, ought not to respond to it. But if an analyst becomes associated with the issuer in the minds of the public, that analyst's projection may carry sufficient credibility to require at least disaffirmance by the issuer.

The SEC's official position on correction of projections has not been consistent. Beginning with a requirement of periodic revision, it shifted to a policy of compelling revision only when a reasonable basis for the projection no longer existed; and now the SEC merely requires management to inform investors that no more updated projections will be furnished.

The permutations and combinations of factual circumstances which might raise a duty to correct, update, or disaffirm are many,


196. Correction may be required if the data were incorrect when revealed. Fischer v. Kletz, 266 F. Supp. 180, 193-94 (S.D.N.Y. 1967).

197. In one case, correction was required even after the actual data were published. Butler Aviation Int'l, Inc. v. Comprehensive Designers, Inc., 425 F.2d 842, 843 (2d Cir. 1970).

Even if not required, regular updating will minimize the risk of liability. C.f. Dolgow v. Anderson, 53 F.R.D. 664, 678-79 (E.D.N.Y. 1971), aff'd per curiam, 464 F.2d 437 (2d Cir. 1972) (finding program of periodic updating with respect to estimates and prospects was not misleading).

198. Commentators are split on this issue, and the cases are inconclusive. See 5 A. Jacobs, supra note 171, § 88.04.

199. Fear has sometimes been expressed that, in this circumstance, if a duty to correct is imposed on the issuer, it will be forced to publish projections. See id. § 88.04(b). However, it would seem that disavowal of the analyst's projection would usually be sufficient. C.f. SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 16 (2d Cir. 1977) (disclaimer that the company could not predict its prospects and could not verify or refute analyst's predictions was sufficient to avoid liability).

and the cases few, to date. But it should suffice to note that we may expect the problems to be more difficult when the items of information invoking the question of duty are soft data.

SUMMARY

Information about the firm is the basis for fundamental analysis of its securities by investors who attempt to determine the risks and returns from investment in individual securities. Among the most relevant, but least reliable, data is soft information, which, until recently, had been kept beyond the pale of formal disclosure in SEC filings, largely because of unreliability.

The Advisory Committee on Corporate Disclosure, in large part because it believes disclosure should be for sophisticates, applauded the SEC's recent moves to permit voluntary disclosure of more soft information and made some recommendations for its further encouragement. The Committee proposed specific suggestions to encourage voluntary disclosure of projections and more meaningful statements in managements' analyses of earnings. It also proposed permissive, voluntary disclosure of dividend and capital structure policy and plans and objectives for firms.

The Committee thereby refused to reject not only fundamental analysis but also the unrelated attacks of SEC critics who believe that formal disclosure in SEC documents is of no utility, largely because all the information thereby disclosed has long before become public knowledge. Without satisfactorily resolving these questions concerning whether SEC mandated disclosure is worth its costs, the Committee, in my view, properly refused to adopt the critics' views on the basis that they have not yet carried their burden of persuasion.

Managers, thus having volition to publish or not publish such items as projections and appraisals, will, among other things, be concerned with potential liabilities for both disclosure and non-disclosure of soft information.

They will not be able to urge successfully that soft information is not a “fact,” subject to misrepresentation, but will be safe from liability for statements which are made in good faith with a reasonable basis, and which are adequately qualified. Moreover, it will often be difficult for a plaintiff to prove that his reliance on unreliable soft data was justified.

Although the removal of the ban on soft information disclosure does not of itself mandate disclosure, it does eliminate an excuse for non-disclosure, thus permitting operation of affirmative duties to disclose under rule 10b-5. However, the very softness of

201. See 2 Bromberg, supra note 66, §§ 6.11(510)-(560).
soft data will provide some defense for non-disclosure on the basis of lack of ripeness. Techniques for determining lack of ripeness that will aid those charged with the duty to disclose are now being formulated. Among the most appealing are the process of balancing relevance against reliability and the suggestion that only data which will have an impact on market price should be considered material. A slightly greater danger exists for insider trading without disclosure of soft information; because of the high degree of relevance of soft information to investors, and because of its abundance, an insider who trades has substantial exposure to a claim that some undisclosed soft datum is material and should be disclosed. Lack of ripeness is a less sure defense here. At the same time, if the insider does disclose, because of the unreliability of soft date, he risks a charge of misrepresentation.

Perhaps because soft data will often not eventuate, the greatest dangers will arise when soft information is published and then, when the facts do not materialize, it is claimed that the issuer or its managers failed in their duties to correct, update or disaffirm the previously published inaccuracy.

For both hard and soft data, difficult problems remain: the extent to which the "half-truth" concept should be applied when only one of two or more unrelated data is published; the duty to supply background data; and the viability of the mosaic theory which seeks to justify tipping of "immaterial" data that, in conjunction with other data already known to the tippee, become material. These problems, most difficult with respect to soft information, await sound judicial, legislative, and executive explanation.