Truth and Consequences—The New Game in Forecasting: Should Our Disclosure Apparatus Co-Opt the Analyst's Crystal Ball?

Geoffrey T. Chalmers

Follow this and additional works at: https://scholarship.law.stjohns.edu/lawreview

Recommended Citation

This Article is brought to you for free and open access by the Journals at St. John's Law Scholarship Repository. It has been accepted for inclusion in St. John's Law Review by an authorized editor of St. John's Law Scholarship Repository. For more information, please contact lasalar@stjohns.edu.
TRUTH AND CONSEQUENCES—THE NEW GAME IN FORECASTING:

SHOULD OUR DISCLOSURE APPARATUS CO-OPT THE ANALYST'S CRYSTAL BALL?

GEOFFREY T. CHALMERS

"Be not the first by whom the new are try'd
Nor yet the last to lay the old aside."

Alexander Pope, An Essay on Criticism

Interested observers of the regulatory scene cannot fail to be struck by recent industry efforts "to reevaluate where and what the obligations are" with respect to predictive analysis. These efforts come at a time of upheaval. The concept of self-regulated markets under full disclosure is everywhere under fire. Drastic structural changes are suddenly proposed and reluctantly agreed upon to preserve investor confidence.

In this heady atmosphere of regulatory frenzy one now hears a simple, direct proposal: The SEC should require an issuer to make public its own forecasts as to future earnings. This proposal, though simple enough to state, marks an historic turning point in the philosophy of securities regulation with implications not yet fully understood. To date, with minor exceptions, issuers must promptly and accurately tell the public only what they have done; the most they can do for an investor is to accurately summarize past history; in general, statements as to what they can or will do are regarded as qualitative evaluations, manipulative per se. Now it is implied that these statements are not

---


2 Indeed, the Interstate Commerce Commission required, effective June 10, 1972, that all applications to issue new securities under §§ 20(a) or 214 of the Interstate Commerce Act (equivalent to § 5 of the Securities Act of 1933) be accompanied by the issuer's pro forma income statement and cash flow statement for the ensuing 12 months. This would become a matter of public record. Ex Parte Order No. 275, 940 I.C.C. 817 (1972), 37 F.R. 7160. See Backer, Reporting Profit Expectations, 53 Management Accounting 38 (1972); Daily, The Feasibility of Reporting Forecasted Information, 46 Accounting Rev. 686 (1971); Willingham, Smith & Taylor, Should the CPA's Opinion Be Extended to Include Forecast?, 38 Financial Executive 80 (1970); Solomon, Pro Forma Statements, Projections and the SEC, 24 Bus. Lawyer 389 (1969); Statement of George Doriot, summarized in Wrong Remedy?, Forbes, Apr. 15, 1972, at 30.

inherently manipulative; on the contrary they are items of information as material to investors as the past record.

The proposal represents a forthright response to a nagging dilemma with which securities regulators perceive themselves to confront in recent years: either force issuers to risk fraud liabilities in order to get disclosure of their projected results or so deprive investors of an essential element of decision-making that the entire disclosure system reduces to an irrelevant burden. The proposal simply chooses the former alternative, directly arousing the resistance of issuers, accountants, lawyers and others.

In discussing the proposal, it will be most useful to define a "forecast" as any language describing a future state of affairs, however general. Also one should avoid confusing (i) the factual element, i.e., that the issuer has, in fact, issued a forecast which it expects to meet and (ii) the judgmental element, i.e., that the forecast implies some conclusive assessment of the company's investment worth.

Those who advocate the new proposal usually employ a combination of the following arguments:

1. The making of an informal ("judgmental") forecast of an issuer's future earnings is a critical preliminary to a good investment decision (buy, hold, sell, vote) with respect to an equity security, since price movements are positively related to earnings results over time.

2. Privileged (i.e., insider, institutional or professional) investors should not have the exclusive right to develop and use "inside" ("factual") forecasts for themselves with the aid of the issuer, as they now do, since this invariably tends to injure the fairness and credibility of the securities markets.

3. Issuers are the best equipped and motivated of all possible sources to produce earnings forecasts useful to investors.

4. Management accountability for performance can be furthered through matching forecasts with actual results.

5. The accounting profession is able to accept responsibility for the reasonableness of forecasts, if a credibility check is needed.

Underlying the foregoing propositions are several assumptions. A basic one is, of course, that the regulatory framework ought to promote dissemination of "material" information to investors as the fairest, most efficient means of policing the markets. See id.; "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." L. BRANDIS, OTHER PEOPLE'S MONEY 211 (1914); H.R. REP. No. 1383, 73d Cong., 2d Sess. 11 (1934), S. REP. No. 1455, 73d Cong., 2d Sess. 68 (1934).
there is an "average investor" who is capable of evaluating any investment decision on his own, if only he is provided with "material" information necessary to that decision. Here the notion is that the disclosure objectives are achieved by eliminating complexity, and by pointing out "material" pitfalls to this average investor. A third is that "material" information is in fact — or can be — actually directly disseminated to all investors in time to affect the relevant decisions. A fourth is that the degree of price and volume variances in trading of an equity security can be directly and negatively related to the degree of adequacy of public disclosure about that security. Excessive market fluctuations are seen as failures of disclosure regulation. A fifth is that issuers are themselves favorably disposed to publish forecasts which are meaningful to investors. Further research is said to be in progress to elucidate these matters.

The foregoing arguments, and assumptions, if valid, support what will amount in the end to a revolution in securities regulation. Some observations do emerge, however, on examining some of the foregoing arguments and assumptions. In particular:

1. The notion that investment decisions as to equity securities are based largely on a projection of future earnings of the issuer is of recent origin and is not universally accepted as effective for all equity securities.

---

5 Levenson, supra note 1, at 68.
10 See Backer, supra note 2. The article is based on interviews with financial executives of 70 companies under the auspices of the National Association of Accountants, indicating that 32.8% of companies visited publicly disclosed profit expectations from three months to a year in advance, another 39.6% regularly communicated with analysts as to the accuracy of their estimates and half of the executives queried (no indication as to companies) were in favor of some form of mandatory yearly forecast. See also Daily, supra note 2 (concluding on the basis of his interviews, that firms would not voluntarily report detailed forecasts).
11 "I think the challenge the whole investment community faces is how it can provide the kind of guidance and professionalization of information, advice and judgment which will keep the small guy in the investment markets. I think that the whole question of money management and the investor's relationship with brokers is going to be carefully scrutinized. I just don't know what the final answer will be." W. J. Casey, quoted in Forbes, July 15, 1971, at 17. See also note 67 infra.
12 At the conclusion of a penetrating analysis of price-earnings data of 178 companies, 1961-65, sponsored by the Institute for Quantitative Research in Finance, Burton G. Malkiel and John G. Cragg recently pointed out that while their system could be said to explain 45-65% of uncorrelated variance in price-earnings ratios from year to year, on the
2. There is not, at present, a demonstrably accurate method acceptable to theorists or analysts, for relating projections of future achievable earnings of issuers to the future market values of their equity securities with any degree of accuracy.\textsuperscript{13}

3. Traded price levels of equity securities can themselves be regarded as projections of future values "prepared" by investors; thus, the trading of securities can really be said to be the purchase and sale of future securities values as affected by present information, or "information futures".\textsuperscript{14}

4. We may be talking about apples and oranges when we talk about the need to give issuer forecasts to investors. The process of preparing an earnings forecast is normally seen by issuers as part of planning and budgeting under management accountability programs; it is questionable whether a securities analyst or sophisticated investor will see the process the same way for purposes of preparing estimates of future securities values;\textsuperscript{15}

basis of published earnings predictions of 19 investment firms, the system was relatively useless in identifying "underpriced" securities. The authors speculate that the old Keynes' "beauty contest effect" is at work, i.e., you pick the newspaper beauty contest winner by choosing the entrant that the other contestants are likely to believe average opinion would consider the prettiest. Malkiel and Cragg, Expectations and the Structure of Share Prices, 60 AM. ECON. REV. 601 (1970). For a popular report of this study, see N.Y. Times, Mar. 11, 1972, at 37, col. 4. For a similar conclusion, as to earnings, based on a study of 12 firms, see Daily, supra note 2. The Daily study noted that while most of the firms could project revenues out five years with a 10% margin of error, one third of the firms had a 15% or greater error margin in projecting net income. See also discussion of English experience, notes 32-39 infra; Mascia, Corporate Earnings Predictions, 25 FINANCIAL ANALYSTS J. 107, 110 (1969): "Once again, the general observation was made that a careful, painstaking forecasting procedure does not seem to be worthwhile in terms of hoping for better results. Thus, the concept of 'normalized' earnings seems to be a good one; Keenan, Models of Equity Valuation, the Great SERM Bubble, 25 THE JOURNAL OF FINANCE 243 (1970);" Bellmore & Ritchie, Investments, ch. 14 (3d ed. 1969) [hereinafter Bellmore]; Graham, Dodd and Cottle, Security Analysis 31 (4th ed. 1962) [hereinafter Graham]; J. Bogen, FINANCIAL HANDBOOK 7 (4th ed. 1964) [hereinafter Bogen]; Supplement to FRIEND & BLUME, WHARTON INSTITUTIONAL INVESTOR STUDY (1970), reported in N.Y. Times, Feb. 16, 1972, at 49, col. 5.


\textsuperscript{14} See Malkiel & Cragg, supra note 12.

\textsuperscript{15} See Harvey Kapnick, Chairman, Arthur Anderson & Co., Statement on Financial Forecasts and the Role of the Independent Accountant, SEC "Hot Issues" Hearings, (File No. 4-148), March 22, 1972 at 3:

While financial statements should assist the investor in assessing the future, interpretations of the future, based in part on information provided by financial statements, must be the responsibility of the investor. . . . The question of separation of an investment judgment, with its corresponding risks and rewards, from the reporting of financial transactions and facts is subtle but important. Information as to management's profit goals, budgetary constraints and plans, or other expectations, may be useful to investors; however, such information is just that—expectation and not fact—and should not be treated in such a way that it acquires a status inconsistent with its true reliability . . .
management's own forecast may be helpful as a "factual" forecast but it is not necessarily as responsive as "judgmental" forecasts to external factors such as how the company will stand up to competition, etc.

5. It is not clear that simplifying the document will necessarily produce better decisions on the part of the small investor.  

6. Given the system, the "average" investor may simply be physically incapable of responding to forecast information in time to translate it into profit; thus, recent analyses of the source of trading volume indicate that response to value changes has increasingly been the province of institutions rather than individuals.

One may well summarize the point of view of the proposal as follows: (i) an earnings forecast is in most cases essential to an investor decision; (ii) earnings forecasts by management are the ones on which investors are most likely to rely; and (iii) forecasts will be most reliable if management is responsible for them in the first instance. The observations made above tend to call into question this point of view and set the tone of this inquiry.

Accordingly, I propose first to discuss some philosophical questions, note the importance of carefully analyzing the informational context and thereafter make an alternative proposal which should meet some of the problems in that context. Lastly, I will make some observations on the state of the securities laws in this area and the position of securities analysts and accountants.

Some Philosophical Questions

Regulatory systems should promote a continual review of the legal concepts which they fundamentally use, to ensure flexible conformity to the felt needs of the time. Fundamental to our system is the concept of immediate disclosure of "material fact". The system defines certain

See also statement of John Gearhart, Director of Investor Relations, Singer Company, in Metz, Market Place, N.Y. Times, June 23, 1972 at 48, col. 2. He states in part: "The artful analyst . . . wants to know the company's shifting competitive position and how the management is reacting to the shift. That's the essence of it. He may even be ahead of management." See also Bellmore; Graham; Bogen, supra note 12.

Georgeson and Company, an investor relations firm, recently studied investor response to annual reports. The study concluded that the average small stockholder spent a bit less than 15 minutes looking at a report. N.Y. Times, March 5, 1972, § 3, at 1, col. 1. See also Wrong Remedy?, Forbes, Apr. 15, 1972, at 30.

See also Institutional Investor Study Report of the SEC to the U.S. Congress, Chapters X-XIII (1971). Conceivably, this response could well be the result of increasing institutional professionalism in the rapid translation of data into precise estimates of securities values.
fact as "material" per se, such as current capital structure, and certain fact as "material" in context, such as a new contract.

Those who constructed the system were aware that business efficiency is promoted by access to relevant information, because business efficiency is in large part the result of allowing control over business assets to move to those with superior ability to make sense out of information. Compensations and rewards in the form of increased profits and control over resources come to organizations which regularly grasp the implications of what they see before others and can act upon their perceptions. Society as a whole is said to benefit from a system which protects this process.

Now we have a proposal to shift the focus of the concept away from the factual and toward the conclusory. Forecasts prepared by the issuer are to become "material" per se (they are already, to a certain extent, "material" in context as indicated below), because to otherwise would be to deprive the investment decision-making process of protection which it needs in order to remain an efficient allocator of resources. This is because allowing unregulated access to forecasts permits investment organizations to buy success in making sense out of information. This undercuts the rational allocation of economic power which is the proud boast of our "free market" system.

There is, however, a tautology in the foregoing chain of reasoning, however laudable its objectives. If successful forecasting is the badge of investor performance, asking issuers to make forecasts makes them, in effect, high-performance investors. An unavoidable logic puts issuers in direct competition with investors in the race to interpret information for investment purposes. Before we had investment organizations "buying" success. Now issuers are to be "selling" it. Both, I suggest, are to be avoided.

A possible solution to the problem may develop if we examine more closely what it is we are trying to protect. I submit that the shift in investor access to information which gives rise to this debate over forecasts is really not as qualitative as one would expect; that what is "bought" by institutions in each case is not really the conclusory forecast but varieties of factual "advance" information. This information is perhaps not significant, separately considered, but, taken as a whole, is highly significant to an understanding of the future. The public, by and large, sees "lagging" and "coincident" indicators of issuer

---

18 See Why Security Analysts Irk Management, BUSINESS WEEK Nov. 6, 1971, at 96: "Management's most common complaint is that analysts keep driving for more and more detailed numbers."
results. The "lead" indicators, while just as factual, remain safely locked in the analyst's files.

If a security is an "information future" then its present value to an investor will always be related to the degree of factual basis for his estimate of that "future". The probabilities associated with predictions are, in the average situation, as important as the predictions themselves.

I suspect that what we are talking about is not the suppressing of ultimate conclusions but the absence of "ultimate fact". The defendant's car hit a tree; the jury will probably decide he was negligent, and that's all the professionals will tell us, till the verdict proves them right or wrong. We should, in all fairness, learn if the defendant was consciously in control of the car, if we are to make up our minds for ourselves.

To be concrete about it, analysts are generally able to extract the categories of "lead time" or "ultimate" factual information about issuers listed below, among others, well in advance of the public. Possibly we should be doing battle with issuers over whether they should disclose these facts, rather than speculating as to whether they should make predictions. Such categories might include:

1. Monthly trend of promotional expense
2. Monthly trend of new orders by product line
3. Monthly sales by product line
4. Monthly cash budget by product line
5. Monthly collection rates on receivables
6. Monthly age on average payables
7. Current working capital position
8. Current "break even" sales rate by product line
9. Monthly trend of orders for inventory components by product or inventory category
10. Current orders for capital equipment, options to buy real estate, etc.
11. Current trend of product liability claims, redemptions or cancellations, etc.
12. Current "per unit" cost and productivity data

Doubtless every securities analyst has his own favorite list of this type of information, which is an essential basis for his forecast, and he's always trying to pry it loose.

Should the fruits of predictive securities analysis be legitimized or co-opted by the regulatory system? If I am correct, the answer is a
partial "yes", to the extent they present "ultimate facts" or "lead indicators" of issuer performance.

The current move by the SEC to require issuer cash flow and budgeting statements in prospectuses of new issues is a move in the direction of factual disclosure which should bring us closer to this objective.\textsuperscript{19}

What, then, is the most efficient way to get this factual information out in the marketplace? I believe that procedural solutions which cause the parties to bring about the chosen state themselves are far more desirable than a set of substantive rules. The procedural is generally easier to understand, cheaper to interpret and enforce, and more widely complied with than the substantive. One treble damage action is worth a thousand administrative proceedings. A study of the informational context of disclosure should indicate the way to a procedural solution.

\textit{The Informational Contexts}

The assumption is that we are encouraging not speculation, but investment based on sound securities analysis. Analyzing a security has never been considered an easy task.\textsuperscript{20} Yet the history of our securities laws is in part the history of an ongoing debate between those who favor complex thoroughness and advocates of direct simplification.\textsuperscript{21} Simplicity is said to aid the "average" investor in grasping the significance of what he is being told, while a mass of detail is an easy mask for deceit.\textsuperscript{22} Others argue that no "average" investor makes — or should make — his own decisions and the quantity, quality and presentation of disclosure should be pitched to the eye of the "reasonable" professional.\textsuperscript{23}

There is little prospect that the debate ever will be resolved, because, like most chronic debates, it arises in part from perceptual discontinuities. The "simplifiers" see the informational context as one in which there are few intermediaries in the information flow from disseminator to decision-maker. Therefore, the responsibility for a simple conclusory impact should rest on the disseminator of the information. The "complicators" see the process as one of filtration.


\textsuperscript{20} See S. REP. No. 47, 73d Cong. 2d Sess. (1934).

\textsuperscript{21} See SEC \textit{DISCLOSURE POLICY STUDY} 51-52 (1969) [hereinafter cited as \textit{WHEAT REPORT}].

\textsuperscript{22} Sovards, \textit{supra} note 8.

\textsuperscript{23} See Backer, \textit{supra} note 2.
through intermediaries, some or all of whom should take up the simplifying task. Neither group is completely willing to concede that the regulatory needs of the context may vary; that it is not homogeneous as to objectives, timing or consequence.

The appearance of projections on the scene may, however, usefully serve to sharpen the focus of debate. A requirement to disseminate projections moves us inevitably in the direction of simple, conclusory disclosure and away from the murk of detail. Yet, as I have argued, it is not fitting in any informational context now regulated for an issuer to project its earnings, though issuers should produce more “ultimate fact”. Therefore, it would certainly appear useful to inquire whether, for all informational contexts now regulated, placing on some intermediary the regular burden of disseminating projections would (i) serve as a useful procedural device to force issuers to disclose “ultimate fact” to the public, (ii) remove an undesirable advantage now held by some investors in decision-making and (iii) promote the right degree of conclusory simplicity for the “average” investor.

In what regulated informational contexts are projections clearly important? It can be argued that projections are important from the minute an investor looks at the security as a possible buy to the minute he has sold it — in short as long as it is traded. Under any theoretical scheme, the projected value of a security changes every minute; practical considerations make it impossible for anyone to put out projections at that rate. As things stand now, we are looking at basically three types of informational contexts (see Appendix A):

1. A “distribution” context, where quantities of a security are being heavily sold.
2. A “corporate action” context where votes or exchanges of securities are being solicited.
3. A “trading” context, where the relative merits of various securities are being discussed or promoted.

It is noteworthy that what we are dealing with in this case is accuracy and velocity. Information must be most accurate. Information must be most rapidly propelled to the furthest reaches of the system.

Now in each context we have information being generated and disseminated by different people, different ways and for different purposes and we have a different mix of decisions being made by

24 See Gonedes, Some Evidence on Investor Actions and Accounting Messages (pts. 1-2), 46 ACCOUNTING REVIEW 320, 535 (1971), arguing that the “transformational strategies” formulated by investors do not respond to publication of annual reports in any identifiable way which affects stock prices. See also, Malkiel & Cragg, supra note 12.
different persons, based in part on the information. Again, the object is
to structure (1) substantive requirements as to types of predictive
information, (2) procedural requirements as to flow and (3) allocation
of responsibility for accuracy and velocity so as to achieve the most
effect with the least regulatory effort.

As indicated in the Wheat Report our focus has, in recent years,
switched from concern over 1933 Act "distributions" to concern with
1934 Act "disclosures". Well it might. While the annual volume of
new equity issues has jumped from approximately $500 million in
1935 to $2.5 billion in 1970, annual exchange trading volume of
equities has jumped from $15 billion to $170 billion. Public share-
holders jumped from 6.4 million in 1952 to 26.4 million in 1968.

Our vast equities markets in this country are, by and large, run by
professionals bound by business and legal duties to standards of care
in the sale of securities. Thus, we are faced with more elusive, complex
problems than the simple frauds going about in the 1930's. For every
Bank of Sark there are a dozen Wrigleys.

The new proposal to have issuers publish forecasts does not really
solve the regulatory dilemma; it merely worsens its effect. Furthermore,
it does not easily fit within the context of a smoothly unfolding policy
responsive to the entire informational context; it is too "1933 Act"
oriented.

If responsibility for the judgmental (as distinct from the factual)
element in forecasts is placed on independent experts we may directly
avoid the dilemma. Fraud liabilities can still be imposed on issuers for
failure to disclose facts material to forecasts; responsibility for errors
or professional judgment in forecasts will rest on the experts. Further,
development of standards for outside experts can carry over into 1934
Act "trading" contexts where issuers may not be directly involved.

An Alternative Proposal

In view of the foregoing, it would seem to me reasonable to
require the presence of forecasts prepared pursuant to substantive
requirements in "distribution" and "corporate action" contexts, where
a certain amount of legitimized selling takes place, during a period

---

25 WHEAT REPORT, supra note 21, at 49. See also Cohen, Truth in Securities Revisited,
26 See WHEAT REPORT, Appendix II-1.
27 Id.
at 47.
28 Id. at note 21.
30 See BUSINESS WEEK, Nov. 6, 1971, at 96. See also BARRON'S, Nov. 1, 1971, at 15; N.Y.
Times, March 30, 1972, at 55 (suits against Bausch & Lomb re forecasts).
"fixed in time" as to values, via prospectuses and proxy statements. It would not seem to me reasonable to impose detailed substantive requirements in "trading" contexts, where the emphasis is on providing the investor with somewhat less precise, but more current, valuation data. Here, the forecaster should be expected to be more sensitive to ongoing developments and to apply more professional judgment in issuing and updating predictions.

It would seem to me reasonable to require the persons doing the selling (i.e., the issuer, underwriter, tender offer or proxy soliciting group) in a "distribution" or "corporate action" context to obtain and distribute through normal disclosure channels (prospectuses, proxy statements or other disclosure statements) a concisely worded predictive statement prepared by an independent expert. The statement should be required, since otherwise only favorable projections will be furnished. We have a precedent in the engineers' reports required in oil and gas or other mineral offerings, where the wording is fairly severely policed by the staff. Possibly the expert should not be the company's independent public accountant (see discussion below). In the "trading" context, one might want to encourage NASD members to make a similar type of forecast, as of a specified recent date, available to buyer-customers.31

The predictive statement should be dated, indicate that it represents an independent professional judgment based on assumptions, indicate how long it can be relied on and be prefaced by a summary of assumptions upon which the expert relies. The assumptions should follow some generally recognized format such as that used in England (see discussion below). To the extent they constitute "lead indicator" data on the company and its plans underlying the factual element of the forecast, the assumptions should be furnished by, and be the responsibility of, the party disseminating the document and both the document and the predictive statement should so indicate. To the extent the assumptions come from outside sources (e.g., general economic data) responsibility for their accuracy and adequacy should rest with the expert.

It would be desirable to emphasize that no forecast under the system should be presented without an estimate of its probability. Further, comparisons of past actual with forecasted performance should be set forth, where available. These, and a number of other more technical procedural devices, should make it quite difficult for people

---

31 I am aware of the complex compensation issues involved, currently under debate. STATEMENT ON FUTURE STRUCTURES, supra note 1. Unfortunately, there is not enough room in this article to cover the matter in adequate detail.
to obtain or promote forecasts to which no reasonable basis can be assigned. For example, it may be wise to prohibit statements by persons connected with market makers, investment bankers or other categories of interested parties.

A special financial analysis unit within the SEC could work with independent professionals to develop self-regulated procedures for generating forecasts, advise the Commission as to new policy questions and interpret difficult cases. The unit would, of course, work closely with the SEC Division of Market Regulations, the NASD and the Exchanges to integrate the new approach with the present system of brokerage house recommendations.

The burden of responsibility for velocity of forecast information would rest on the sellers in a "distribution" or "corporate action" context, and might be allocated between the NASD members and the analysts in the "trading" context.

The foregoing alternate proposal should be distinguished from similar proposals which would have the company prepare the forecast and the independent expert verify the reasonableness of the underlying assumptions in a manner similar to the British system (see below). I do not believe that these proposals would really solve the regulatory dilemma as set forth in this article and they would probably complicate allocation of responsibility between the issuer and the independent expert. Like the initial proposal, they do not look toward a coordinated disclosure policy over the entire informational context.

Referring back to prior discussion of issuer responsibility for "ultimate fact", I submit that the foregoing procedural approach to complex disclosures in forecasting will force issuers to give out a multitude of advance data to parties eminently qualified to evaluate it and bound by law to make that evaluation public as quickly as possible. In the never-ending debate between "simplifiers" and "complicators" we will have good answers for both sides: quick, simple recommendations publicly available to all "average" investors, plus additional detail publicly available for evaluation by professionals.

The British Experience

It is worthwhile examining the British experience in this connection. Profit forecasts for the current year prepared by management have long been included in documents describing capital issues on

---

the London Market. It appears that such forecasts are generally conservative matched against actual results. As of May 1, 1969, there was constituted by the Bank of England a City Working Party for the purpose of considering good business practices in the conduct of takeovers and mergers, and on that date the Working Party, composed of members of the banking and securities industries, issued the City Code on takeovers and mergers and provided for a Panel on Takeovers and Mergers to enforce it. Among other things, the Code was designed to counter pressures on managements to issue irresponsible profit forecasts in connection with a takeover battle. Rule 16 of the Code does not require the generation of profit forecasts; however any profit forecasts contained in any document addressed to shareholders in connection with an offer (i) must be compiled by the Directors "whose sole responsibility they are", (ii) must contain a statement of the assumptions on which the forecasts are based, and (iii) must have their accounting bases and calculations examined and reported on by auditors or consultant accountants. Any financial advisor mentioned in the document must also report on the forecasts. These reports must be included in the document together with a consent to publish.

The Panel has issued two Practice Notes on rule 16. Practice Note 4, first issued in June, 1970, requires among other things, that the forecasts be used no more than 60 days. Practice Note 6, first issued in June, 1971, goes into the position of accountants and financial advisors in reporting on forecasts. While the forecasts and assumptions are to be the responsibility of the Directors, neither the accountants nor the advisors "should allow an assumption to be published which appears to them to be unrealistic (or one to be omitted which appears to them to be important) without commenting on it in their reports". The Panel does not appear to wish to take a rigid approach to the form of the forecast, the assumptions or the reports.

It is noteworthy that the Panel regards a forecast to have been made, requiring full treatment, where any general language appears as to future profits. No time limit is placed on the forecasts and many go out as far as five years.

34 Id.
35 The City Code on Takeovers and Mergers, February, 1972 Revision.
36 Practice Note 6, City Code, February 16, 1972 revision, para. 6.
37 However, certain practices have grown up. Apparently, it is common to include assumptions as to inflation, sales volume, sales price and costs. See Assumptions and Profits Forecasts, The Accountants Magazine, January, 1972, at 13.
The Panel reports as of March 31st of each year on the results of its work. From May 1, 1969 through March 31, 1972, it has reviewed 173 cases of forecasts of which 122 were achieved within a 10% margin of error and 16 were "not comparable with results." Of the 35 "failures", 26 were by offeree companies.38

The British rules appear to work well in practice. They do not have the force of law, but in the inimitable British fashion, are cooperatively observed by the closely-knit financial community of the City in a manner designed to insure speedy action.39 A noteworthy feature is the careful follow-up by the Panel of actual results and lengthy inquiry in cases where they are way out of line with forecasts.40 It is not clear to what extent the British forecasting practice could be safely imported into the U.S. regulatory system. However, it is reassuring to know that results to date have not been a disaster.

Legal Problems — Allocating Responsibility

There is no question that the SEC has the power to require the insertion of predictive statements in prospectuses41 and proxy statements or tender offer literature.42 Further, it can regulate the form of predictive material prepared by broker-dealers43 and investment advisors.44 To a certain extent, it can control the degree to which this material has the status of expert information under the 193345 and

40 Statement of Robert A. Clark, Esq., id. at 259.
44 §§ 204, 206, Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-4, 80b-6 (1971). In this connection it is interesting to note that the SEC will be moving more aggressively in this area, since the exception for investment advisors solely to mutual funds was removed, effective December 14, 1971. There are a number of technical Investment Company Act issues raised by the proposals, but these are deemed beyond the scope of this article.
1934 Acts, so as to allocate the responsibilities in the manner above described.

Naturally, a careful review will have to be undertaken of negative pronouncements on predictions currently in effect and of rules relating to recommendations and reports in connection with distributions.

The Courts have been somewhat confused in applying disclosure principles to prospectuses or proxy statements involving valuations or projections. In the recent Chris-Craft case for example, the U.S. Court of Appeals for the Second Circuit reversed and remanded a District Court finding that stating the value of a securities package in an exchange offer press release was not a violation of the 1933 Act. In the Gamble Skogmo case, the U.S. Court in the Eastern District of New York found it a violation of the 1934 Act not to include in a merger proxy an estimate of the fair market value of the assets of the acquired company even though the defendant had been told by the SEC (and the SEC argued in an amicus brief) that such inclusion would be misleading. Doubtless these confusions can be dispelled by clear SEC leadership in developing rules for disclosure under the 1933 Act.

More troublesome questions arise with respect to rule 10b-5, the enfant terrible of securities regulation newly upon us. Here we have a body of “Federal corporate law” which the courts have developed largely by themselves without significant rule-making direction by the SEC. The big problem we have here is that the courts are starting to develop their own notions of what, in the way of predictions, is a “manipulative or deceptive device or contrivance” under section 10(b) of the 1934 Act, or a “practice or course of business which operates or would operate as a fraud or deceit” under rule 10b-5 and section 17(a) of the 1933 Act. This has already complicated the “gun jumping” problem.

To date, we have not had a full-dress treatment of predictions in

---

47 See Securities Act Release No. 5180, supra note 3 and text accompanying note 37, supra. See rule 14a-9 of the Commission’s Proxy Rules, 2 CCH Fed. Sec. L. Rep. ¶ 24,013. See also WHEAT REPORT at 17, 95. Stock exchange disclosure rules will also have to be examined such as The American Stock Exchange Company Guide 103 (1970) and THE NYSE COMPANY MANUAL A-18 to A-27 (1970).
52 See note 40 supra and accompanying text.
court. Facts have been the main concern. The 1968 statement of Judge Waterman in *Texas Gulf Sulphur* is probably good today, as far as courts are concerned:

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 on their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders.\(^{53}\)

Judge Waterman recognized the inclusion of "lead indicator" or probabilistic fact, in the regulatory scheme:


\[54 \text{SEC v. Texas Gulf Sulphur Co., 401 F.2d at 839. The SEC has defined "materiality" as "matters as to which an average prudent investor ought reasonably to be informed before purchasing (1934 Act: "buying or selling") the security registered", 1933 Act rule 405(1); 1934 rule 12b-2(i).}


\[53\]... thus, material facts include not only information disclosing the earnings and distributions of a Company but also those facts which affect the probable future of the Company...\(^{54}\)

The SEC's ruling in the *Merrill Lynch* case\(^{55}\) may represent a different theory, in view of the careful use of the phrase "material information" rather than "material fact". The case does involve earnings projections. However, the gravamen of the case is clearly the fact that the Douglas Aircraft Company was, in late June, 1966, about to release to the press actual earnings for the six months ended May 31, 1966, considerably lower than the 94 cents per share reported for the five months ended April 30, 1966. This fact alone would have caused a market drop whether or not coupled with reduced earnings forecasts. In the related *Investor's Management*\(^{56}\) case, the SEC stated:

\[56\]... in testing materiality, the importance of reliability in terms of the underlying accuracy of the information wanes as that accorded to the character of the information increases. Thus, a company's own earnings results and own projections which are of manifest
importance to investment judgment fall nevertheless in the category of material information though subject to future judgment or reconsideration. If, of course . . . information is so unreliable that a reasonable person would refuse it credit, there would be no reason to regard the information as material.

One certainly should have no quarrel with the basic thought here. Issuers should and do have a duty to respond to forecasts going around which are clearly out of line.57 However, there is a trap, as clearly pointed out by these rule 10b-5 and related antifraud rulings. They are tending to require issuers to affirmatively come forward with their own forecasts, when in their own judgment such forecasts have become "material" to investors. Yet when these forecasts are put out, they are cause for later liability on grounds of unreasonableness if they are not met.

Rule 10b-5 sanctions have their proper place in the regulatory arsenal. However, I submit that they are far too heavy-handed a tool for dealing with the fabric of delicate policy issues surrounding the proper status of forecasts. A device which has to fumble with the concepts of "scienter," "reliance," and "action" is far too unwieldy a bull to let loose in this china shop.

One of many examples: in Milberg v. Western Pacific Railroad,61 the Court (Croake, J.) denied the plaintiff's motion to establish a class action against the defendant Railroad and Dow Jones and Company. The plaintiff alleged a purchase of railroad shares on June 12, 1969 on the basis of a May 19, 1969 article in Barron's magazine stating that Railroad net for the June quarter "is expected to show some improvement" over net for the prior year. In fact, June quarter earnings amounted only to 25 cents per share, as against 84 cents, and the announcement then triggered a sharp drop in share prices causing the plaintiff's loss. Plaintiff alleged either (1) that the article was based on misleading information supplied by Railroad or, if not, (2) that the article was written with a reckless disregard for the truth. In a stinging


paragraph or two Judge Croake dismissed the plaintiff's theory, calling it, among other things, "a rather self-seeking attempt to infringe upon defendant's First Amendment rights as well".

Decisions like the foregoing represent prime examples of the inevitable heavy-handed trend of "Federal corporate law" to place forecasting disclosure burdens on the wrong parties in the wrong way in the wrong contexts, a tendency accelerated by the current debate over the subject. Unless the SEC acts fairly rapidly to develop a comprehensive, carefully planned series of changes in its rules, it may find that the courts have done the job for it, in a way too embarrassingly final to alter.

**Legal Problems — Liabilities**

Who should be allowed to recover against whom in the case of an improper forecast? The problem appears quite difficult under the initial proposal; there, forecasts are unavoidably placed on the same liability level as factual corporate information. A foretaste of the judicial contortions that will result can be found in *Feit v. Leasco Data Processing Equipment Corp.* Here, a former shareholder of Reliance Insurance Company was held entitled to recover from Leasco and three "inside" directors (but not the investment bankers) for violation of the 1933 Act, section 11, in that Leasco had failed to include in its exchange offer prospectus for Reliance shares an estimate of the probable value of Reliance's excess reserves ("surplus surplus" in insurance parlance). Information on these reserves could not accurately be obtained from anyone other than Reliance; independent actuarial reports placed them at between $80 and $125 million. Experienced SEC counsel for Leasco and its investment bankers both advised that the information in hand was too speculative to pass the tests of accuracy required in a prospectus. Reliance was not, at first, cooperative on the subject and exact information could not, at first, have been obtained from Reliance. Nevertheless, the Court held that an estimate was a key element of Leasco's interest in Reliance and was therefore "material" to investors.

---

62 51 F.R.D. at 282.
63 The Judge may not have been aware of the line of cases cited on this point by Judge Waterman, in the *Texas Gulf* case, 446 F.2d at 1302 (2d Cir. 1971), to support his ruling that "the First Amendment deals with the exchange of ideas and not with commercial 'factual' speech."
64 I am not, of course, out to place the responsibility on BARRON'S in all cases like this. I just think that the issues should not have been decided without a more penetrating recourse to the facts. New cases arise every day for which this approach may be dangerous precedent. *See* Complaint, *Foster v. National Systems Corp.*, CCH FED. SEC. L. REP. ¶ 93,522 (C.D. Cal. June 14, 1972).
Insiders could have obtained a reasonable estimate due to a sudden change in Reliance's attitude two weeks before the registration statement became effective. Outsiders, such as the investment bankers, were nevertheless entitled to rely on Leasco's steadfast representation that Reliance was still hostile. Therefore, the outsiders had met the "reasonable investigation" defense of section 11(b). Counts under the 1933 Act, sections 12 and 17, and 1934 Act, sections 10(b) and 14(e), were dismissed as surplus to recovery.\footnote{66 For a similar effect under the proxy rules, see Gerstle v. Gamble-Skogmo, 298 F. Supp. 66 (E.D.N.Y. 1969).}

While the facts of each case will be complicated, I think we can see in Leasco the outline of things to come. Evaluative information will be ruled "material" to investors if management can be said to have considered it so at the time (with the benefit of hindsight). Insiders will be held liable for failure to estimate properly; outsiders (including experts) will be exonerated if the record shows that they made the proper inquiries, regardless of any exercise of judgment. As a result, the same old forces will prevail, predictive statements will be excessively vague and elaborately footnoted and the "due diligence" inquiry even more of a charade than it now is.

If, however, we make a firm rule requiring mandatory predictive statements prepared by outside experts, the roles are reversed (as they should be). Management knows that these statements have to be prepared in all cases. The outside expert is directly responsible for the reasonableness of factual assumptions in predictive statements prepared by him under the 1933 Act, section 11(a)(4); however, he has a "due diligence" defense with respect to facts furnished him by the registrant under section 11(b)(3). Insiders have a similar defense under section 11(b)(3) with respect to the judgmental element in the expert's certificate. As a result, we encourage a short, specific judgmental expert report accompanied by reasonable, coherent factual assumptions. Liabilities are directly related to functions performed, not to whimsical judicial journeys along a paper trial.

\textit{Position of U.S. Accountants}

Part of the picture is, of course, the current ferment in the U.S. accounting profession over whether to adopt in this country the 1969 pronouncement of The Institute of Chartered Accountants in England and Wales, stating that accountants may "verify that... forecasts have been properly computed from the underlying assumptions and data and are presented on a consistent basis".\footnote{67 In the cases of takeovers, reporting accountants must make a check as to reasonableness. See text accompanying notes 32-36, supra. See also IGA, ACCOUNTANTS REPORTS} The U.S. accounting pro-
fession has not gone this far. The AICPA exerts control over the situation chiefly through rule 2.04 of The Code of Professional Ethics and Opinion No. 10 which "interprets" the rule. While the Opinion was somewhat relaxed in 1970, the general approach is to require any "statement or analysis" with which a member "associates his name" to set forth the source of the information, major assumptions, the "character of the work" done on it by the member and the degree of responsibility he is taking. In addition a member's document associated with it must "clearly indicate that the member does not vouch for the accuracy of the forecast".

Now, there is, in my opinion, everything to be gained by clearly separating the function of reporting on past operations and passing on the reasonableness of future forecasts. There is nothing wrong with trying to develop a method for achieving continuity of accounting treatment of predicted results. However, if this involves a company's independent public accountant, he will inevitably be forced to choose between justifying past projections or reporting current earnings properly. Furthermore, at least one eminent member of the profession has pointed out that the performance of services by independent public accountants in connection with forecasts will only accelerate the deplorable current trend away from professional independent fact verification towards a biased, unprofessional involvement with clients' business affairs.

Forcing responsibility on accountants for the accuracy of forecasts would appear to be undesirable if more appropriate kinds of independent experts can be found to do as thorough a job.

Will Analysts Give Up Their Crystal Ball?

Ominous portents for securities analysts lurk in Merrill Lynch and Investor's Management. Like it or not, the gauntlet has been

---

As Profits Forecasts 7 (July, 1969). For an argument in favor of certified forecasting, see Daily, supra note 2. The author makes the interesting proposal that forecasts should be allowed if they are "material," i.e., if the company has demonstrated reasonable accuracy in the past as shown by its record. Contra, Harvey Kapnick, supra note 15. See also Williams, Smith & Taylor, supra note 2.

43 Rule 2.04 reads as follows:
A member or associate shall not permit his name to be used in conjunction with any forecast of the results of future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast.

49 The AICPA has put its semi-official stamp on a further gloss of the text. See Belda, Reporting on Forecasts of Future Developments, 130 JOURNAL OF ACCOUNTING 54 (1970).


71 Kapnick, supra note 15, at 11.
thrown down. Odors of "insider privilege" fill the air when analyst meetings are discussed. Yet in this uncomfortable situation the analyst community has for a brief time a big opportunity to move to new levels of professional stature.

If the original proposal is implemented, rules allowing issuers to provide their own forecasts may well be accompanied by rules foreclosing analysts from the real or imagined "inside track" to material corporate information. The investment advisory community can, in that event, expect its operations to be constricted by a stiff new set of rules and to bear for some time a faint onus of shady practice. These developments would be indeed regrettable.

Responsible members of the analyst community can counter these developments now by stepping forward to support an alternate proposal similar to those here advocated. This strategy will involve much hard work developing a body of standards. Nevertheless, it will successfully preserve hard-won professional freedoms and materially aid the cause of investor confidence which is the rational operative of our securities markets.

Efforts to step forward with a comprehensive program for professional forecasting will have other positive benefits. After ten years of debate over the methodology of forecasting, academics still can not, as a whole, present the profession with a coherent body of theory linking earnings variability with investment returns on equities. Most practitioners, by and large, still use the old tried and untrue method of relating predicted or "normalized" earnings to a predicted or "normalized" P/E ratio. Developing a regular data base comparing professional predictions with reported results over time can only help to increase the precision of academic forecast techniques and their attractiveness to the average analyst.

One certainly is aware of the dangers involved. BarChris liabilities are not easily faced by professionals. On the other hand, the rewards are probably going to be greater, in the long run, for the profession as a whole.

75 See Keenan, supra note 12.
78 "The critical dependence of share prices on expectational variables has proved to be a major obstacle for empirical investigators. Since only historical data have been available to most researchers, it has been difficult to isolate the true effect of the various variables affecting stock prices." Malkiel & Cragg, supra note 12, at 603. See also Daily, supra note 2 (suggesting a system for evaluating forecasting accuracy).
One can sense these evaluations at work. The Second Seaview Symposium on financial reporting in part sponsored by the Financial Analysts Federation concerned itself at length with published forecasts. The Federation appears to be cautiously developing a series of positions on forecasting which can be accepted by significant elements of the financial community. For example, it generally supports the SEC position on requiring cash budget statement in new issue prospectuses. One is encouraged by these and other efforts to bolster self-regulation.

**Will the Public Benefit?**

Every good regulatory system should achieve, through planned cooperation, maximum effect with minimum wasted effort. There is no reason to quarrel with our basic disclosure system; over the years it has worked "as advertised" to improve the quality of public finance. In fact it has worked so remarkably well that we should undertake fundamental changes with extreme care, lest valuable relationships be buried or distorted to our regret.

Something must be done about predictive securities analysis. Institutionalization of our markets, complexity and rapidity of reporting, now demand a decisive regulatory act. If false steps are taken they can shake very fundamental relationships. Here, a procedural solution is suggested which should preserve the best features of the old while accommodating the new. If it works, the public can only continue to benefit.

**APPENDIX A**

FACTORS INVOLVED IN REGULATING THE FLOW OF INFORMATION IN SECURITIES TRANSACTIONS

I Categories of Information Involved

A. Subject Matter
   - "Basic" fact directly/indirectly involving the Issuer's operations/market price of security.
   - "Ultimate" or "conclusory" fact directly/indirectly involving the Issuer's operations/market price of security.
   - "Predictive" data, e.g., prediction as to future "basic" or "ultimate" fact, directly/indirectly involving the Issuer's operations/market price of security. NOTE: "Predictive" data, will always carry with it a "probability" factor, express or implied.

B. Authoritative Weight
   - Official pronouncement by regulatory authority.
   - "Expertized" information.
   - Consensus information.
   - Other.

---


81 See note 18 supra.

C. Presentation Emphasis
   — Immediately significant.
   — Significant but not immediately.
   — Not of great significance.
D. Desired Destination
   — Nonpublic.
   — Official filing or report.
   — Selective public distribution.
   — Broadest public distribution.
E. Medium
   — Research or other private report or statement.
   — Report other legal document required to be filed by law.
   — Informal telephone or oral presentation or statement.
   — Prospectus, proxy statement or similar widespread selling document.
   — Press release, news story or similar public announcement.

II Types of Decisions To Be Made in Response To The Information
A. Decisionmaker
   — Fiduciary institution or individual.
   — Professional investment manager, institution or individual.
   — Private investment institution or individual.
   — Public investment institution.
   — Broker.
B. Investor’s Objective On The Risk/Reward Curve
   — Defensive, e.g., saving, tax, hedge, etc.
   — Long term return.
   — Trading return.
   — Control.
C. Investor’s Objective As To Portfolio Insertion
   — Diversified/concentrated.
   — 100% owned/levered.
D. Investor’s Objective(s) as to Nature of Return
   — Appreciation in traded value.
   — Appreciation in “appraised” value (e.g., control situation or mutual fund).
   — Income stream.
E. Investor’s Objective as to Timing
   — Increasing position.
   — Decreasing position.
   — Voting.

III Context in Which Flow of Information Affects Decisions
A. Formal Structure of Market for Security
   — Listed existing/new security.
   — OTC existing/new security.
   — Untraded private transaction.
B. Liquidity of Potential Transaction
   — Size of “float” and trend/cycle effects.
   — Relative size of position involved.
C. Objective of Person(s) Disseminating the Information
   — Obtaining purchase or sale of security.
   — Obtaining vote of security holder.
   — Compliance with disclosure or other requirement.
   — Response to inquiry.
D. Effect of Flow on Decision
   — A proximate cause of decision.
   — A necessary cause of decision.
   — A factor bearing on decision.
E. Organizational Process of Decision
   — Individual/Investment Committee.
— Self-researched/advised.
— In-house/contracted for.

F. Element(s) of Decision Affected
— Assessment of future economic conditions in issuer's market.
— Assessment of issuer's future position in markets.
— Assessment of issuer's future earnings, cash flow or financial position.
— Determination of multiple, discount or other factors to be used to reach estimate of future value.
— Estimate of time in which future value will be reached.
— Estimate of relative probability of reaching value in time allotted.
— Assessment of desirability of present action in the light of expected short term market movements for total market, group and/or particular security.