GETTING IT RIGHT VERSUS GETTING IT QUICK: THE QUALITY-TIMELINESS TRADEOFF IN CORPORATE DISCLOSURE

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I. INTRODUCTION

The objectives of quality enhancement and timeliness appear high on the lists of those structuring securities disclosure regulation. That a disclosure regime should be assessed, at least in part, by its ability to promote the delivery of accurate, complete, and reliable information to investors seems almost axiomatic. That such a regime should not, at the same time, induce unnecessary delays, or that it should actually ensure the timely dissemination of information to the capital market, is also a widely accepted criterion for assessment. There are, of course, other criteria for evaluation—the impact of the regulation on the corporate issuers' day-to-day operations, for example—but none with the salience of these two.

These dual objectives—the delivery of *high quality*[1] and *timely*[2] information to the public—have been heavily relied upon by the Securities and Exchange Commission ("SEC") and Congress to justify recent far-reaching initiatives to reform the corporate disclosure regime. For example, under the stated purpose of "improv[ing] the delivery of *timely, high quality* information to the securities markets to ensure that securities are traded on the basis of current information,"[3] the SEC has accelerated the filing by issuers of their quarterly and annual reports.[4] In addition, the SEC has proposed a rule that would expand the list of significant events requiring disclosure on existing Form 8-K. Such events could include the entry into or termination of a material agreement and the creation of a material financial obligation.[5] The same proposed rule would also accelerate reporting of Form 8-K to two business days following these triggering events, instead of the existing deadline of five business days or fifteen calendar days, depending on the nature of the event.[6] These SEC initiatives have found congressional endorsement in the Sarbanes-Oxley Act of

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[1] For purposes of this section of the Survey, the term "high quality" disclosure refers to the optimal amount of accurate and reliable information about a company and its securities that assists, rather than hinders or confuses, an investor in making his or her investment decisions.

[2] The term "timely" disclosure, as used in this section of the Survey, refers to the prompt dissemination of information upon the occurrence of any corporate events that are relevant to the investment-making decision.

[3] Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 67 Fed. Reg. 42,914-01 (proposed June 25, 2002) (to be codified at 17 C.F.R. pts. 228, 229, 240, 249), *available at* http://www.sec.gov/ rules/proposed/33-8106.htm (last visited April 14, 2003) (emphasis added) [hereinafter Proposed Rule on Additional Form 8-K Disclosure].

[4] Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Securities Act Release No. 33,8128, 68 Fed. Reg. 17,880-01 (September 16, 2002) (codified at 17 C.F.R. pts. 210, 229, 240, 249) [hereinafter Rule on Acceleration of Periodic Reports].

[5] *See* Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3. *See infra* III.B.3 for further discussion of Form 8-K proposals.

[6] *See* Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3. *See infra* III.B.3 for further discussion of Form 8-K proposals.

2002,[7] which, among its myriad directives, calls for additional[8] and prompter[9] current disclosure of certain events.

The pervasiveness of initiatives designed to improve concurrently the quality and timeliness of disclosure suggests that Congress and the SEC view them, to a certain extent, as compatible goals. Indeed, numerous SEC releases have propounded these dual objectives alongside one another,[10] and have highlighted technological advances on information flow to justify the feasibility of producing both faster and higher quality disclosures.[11] Yet, an important

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[7] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.) [hereinafter Sarbanes-Oxley Act].

[8] *See, e.g.*, Sarbanes-Oxley Act § 401(a)-(b) (specifically, § 401(a) requires disclosure in Management Discussion and Analysis ("MD&A") of off-balance sheet arrangements and aggregate contractual obligations; § 401(b) pertains to conditions for use of non-GAAP financial measures).

[9] *See* Sarbanes-Oxley Act § 409 ("Real Time Issuer Disclosures").

[10] *See, e.g.*, Timely Disclosure of Material Corporate Developments, Securities Act Release No. 5092, 35 Fed. Reg. 16,733 (Oct. 15, 1970) (acknowledging that a publicly traded company had "an obligation to make full and prompt announcements of material facts regarding the company's financial condition"); Securities Act Release No. 5511, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,834, at 84,254 (July 3, 1974) (stating that the SEC "reiterates that, as a matter of policy, prompt and accurate disclosure should be made to the investing public with respect to information, both favorable and unfavorable; concerning the current availability of such firms' natural gas supplies"); Securities Act Release No. 5447, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,607, at 83,629 (Dec. 20, 1973) (reiterating the need for "prompt and accurate disclosure of information, both favorable and unfavorable"); Securities Act Release No. 5263, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,852, at 81,865 (June 22, 1972) (emphasizing "the need for . . . prompt and accurate disclosure . . . of material information, both favorable and unfavorable, with respect to progress and problems encountered in the course of performing under long-term contracts").

[11] *See, e.g.*, Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3, at Part 4(b) ("[D]evelopments such as EDGARLink . . . enable a company to file reports easily and directly, without the added costs of using third parties to submit filings, with the Commission over the Internet, and the industry's increased experience over the past several

question arises as to whether, and to what extent, the objectives of quality and timeliness are in tension with each other. That is, can a disclosure regime realistically aim to achieve both objectives simultaneously? Or, are there significant tradeoffs between these objectives that thwart efforts to concurrently fulfill both?[12]

This section of the Survey aims to explore the nature and extent of this quality-timeliness tradeoff, and, in the process, to analyze the effectiveness of various approaches to tackling it. In order to provide a backdrop for the discussion, Part II surveys the historic emphasis on quality and timeliness in securities regulation. Part III reviews the regulatory framework of the disclosure regime and highlights recent congressional and SEC initiatives, including the disclosure-related provisions of the Sarbanes-Oxley Act and amendments to Form 8-K, each aimed at concurrently achieving the two objectives. Part IV distills examples from these recent SEC initiatives to identify the nature and extent of the tradeoff between the two objectives. Part V introduces and critiques the SEC's efforts designed to minimize the tensions, and Part VI sets out a number of recommendations. This section of the Survey concludes by

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years using the EDGAR system should minimize companies' cost of filing more Form 8-K reports in a shorter timeframe."). For a general discussion of the impact of technological advances on the securities markets, *see* SEC, REPORT TO THE CONGRESS: THE IMPACT OF RECENT TECHNOLOGICAL ADVANCES ON THE SECURITIES MARKETS (Nov. 26, 1997), *at* http://www.sec.gov/news/studies/techrp97.htm (last visited Apr. 14, 2003); Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747 (1985); M.H. Wallman, *Regulation for a New World*, 6 BUS. L. TODAY 8 (1996); Jennifer L. McDonough, *Electronic Media and the Federal Securities Laws: Perks, Pitfalls and Prudence*, 39 DUQ. L. REV. 823 (2001).

[12] The author posits that the relevant securities regulators have insufficiently addressed the tradeoff, *not* that they are oblivious to it. Indeed, the SEC has recognized this tradeoff recently in its final rule to accelerate the filing deadlines for Forms 10-K and 10-Q. *See* Rule on Acceleration of Periodic Reports, *supra* note 4, at n.34 ("Increased quality and timeliness, *with an appropriate balance between the two*, assures that investors receive the full and reliable data they deserve at the speed in which they desire it.") (emphasis added).

positing that, while the goals of quality enhancement and timeliness are individually valid, each must be balanced against the other. Accordingly, securities regulators and standard setters, in refining and interpreting the disclosure requirements, would be well-served to recognize the importance of the tradeoff and strike an appropriate balance.[13]

II. THE OBJECTIVES OF QUALITY AND TIMELINESS

A. The Objective of High Quality Disclosure

Federal securities regulation proceeds from the premise that quality information allows investors and other market participants to evaluate the risks and returns associated with owning a security. As Federal Reserve Chairman Alan Greenspan emphasized, "[i]nformation is critical to the evaluation of risk. The less that is known about the current state of a market or venture, the less the ability to project future outcomes and, hence, the more those potential outcomes will be discounted."[14] U.S. Supreme Court Justice Louis Brandeis, a strong proponent of disclosure as a means of reducing corporate wrongdoing, also touted the benefits of high quality financial information in his famous remark, "sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[15] In recommending that

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[13] While this section of the Survey offers a framework for the analysis of the tradeoff, it does not pretend to resolve the tension or propose the "right" balance. Instead, it embraces two more humble goals. First, the following overview of recent SEC initiatives and the analysis of the dual objectives are intended to illustrate the importance of recognizing the inherent tradeoffs between the dual goals. Second, the subsequent discussion of recommendations aims to provide a point of reference for reforms.

[14] Dan Seligman, *24-7 Accounting: Controversial Solution to the Problem of Stocks that Implode After Earnings Surprises: Real-Time Financial Reporting*, FORBES, Oct. 30, 2000, at 146.

[15] LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY 62 (National Home Library Foundation Edition 1933) (1914).

Congress pass the Securities Act of 1933, President Franklin Roosevelt wrote: "there is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public."[16]

1. The Benefits of High Quality Disclosure

High quality disclosure is associated with a variety of benefits. Three of the most commonly cited are informational efficiency, allocative efficiency, and investor protection.

First, high quality disclosure is said to satisfy the information needs of investors, and thereby increase the amount of investment.[17] The basic idea is that if investors generally believe that they do not have enough information to make informed choices, they will lose confidence in, and may even boycott, the capital markets.[18] Because self-help remedies for potential buyers (such as personal inspection) are often unavailable and infeasible in the securities market, the investor needs reliable information about the issuer's financial condition, expected future earnings, competitive standing, assets and liabilities, and management, as well as an array of other considerations, to be presented in a relatively standardized and uniform fashion to facilitate

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[16] H.R. REP. NO. 73-85, at 2 (1933).

[17] *See, e.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984); Gregg A. Harrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J. L. & ECON. 613 (1981). *See also* H.R. REP. NO. 73-1383, at 11 (1934) (expressing that disclosure promotes efficiency as a result of stabilization and protection of investors).

[18] *See* Rule on Acceleration of Periodic Reports, *supra* note 4, at Part IV.A.2. (stating that "[i]nvestors and the capital markets may suffer if quality or accuracy diminished, causing the markets to function less efficiently and investment decisions to be impaired").

comparisons among securities. Absent quality disclosures, investors arguably would not be willing to invest funds in such uncertain enterprises.

Second, high quality disclosure, according to many, equips securities investors and markets with the information to move capital to its optimal uses.[19] This goal of allocative efficiency is considered significant because resources (in this case, capital) are scarce and must be allocated among competing corporate issuers. Through assessing the cost of capital for issuers, the securities markets are said to channel capital to companies with superior prospects and penalize inferior companies by making it harder for them to obtain capital. As Professor Merritt Fox explained, quality disclosure "improves how proposed new investment projects in the economy are selected for implementation and the way existing projects are operated."[20]

Third, and most historically important, high quality disclosure helps to protect investors against securities fraud.[21] The first major federal securities laws were passed during the Great Depression, following the 1929 stock market crash. Congress was of the impression that investors had been systematically cheated during the financial heydays of the 1920s.[22] It was argued that full and mandatory disclosure of corporate information was needed to

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[19] *See, e.g.*, Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 979 (1992); Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 802 (1985); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 601 (1984).

[20] Merritt B. Fox, *Markets and Information Gathering in an Electronic Age: Securities Regulation in the 21st Century: Rethinking Disclosure Liability in the Modern Era*, 75 WASH. U. L.Q. 903, 908 (1997). *But see* Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988) (questioning the assumption that an efficient market is able to allocate scarce resources in the economy).

[21] *See, e.g.*, Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1983).

[22] *See* H.R. REP. NO. 73-85, at 1-4 (1933).

protect investors who were vulnerable in a manipulated marketplace.[23] Accordingly, the federal securities regulations' emphasis on consumer protection is reflected in the two major federal securities laws: the Securities Act of 1933 (the "Securities Act"),[24] and the Securities Exchange Act of 1934 (the "Exchange Act").[25]

2. The Costs of High Quality Disclosure

The foregoing advantages attributed to high quality information are neither absolute nor free from critical evaluation. As many commentators have pointed out, mandating disclosure of quality information often involves significant preparation costs.[26] Preparing a report for

[23] The goal of consumer protection may be even more pertinent, in recent times, as nearly half of American households (an estimated 52.7 million) owned equities in 2002. *See* INVESTMENT COMPANY INSTITUTE & THE SECURITIES INDUSTRY ASS'N, EQUITY, OWNERSHIP IN AMERICA (2002), *available at* http://www.ici.org/pdf/rpt_02_equity_owners.pdf (last visited Apr. 14, 2003).

[24] The Preamble to the Securities Act of 1933, 48 STAT. 74 (codified as amended at 15 U.S.C. §§ 77a-aa (1997)) (stating that the purpose of the Securities Act is "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes").

[25] Securities Exchange Act of 1934, 15 U.S.C. § 78a (2000) (stating that the purpose of the Exchange Act is "to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes"). *See id.* § 2.3 ("Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control . . . ."); *id.* § 2.4 ("National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets.").

[26] *See, e.g.*, Timothy P. Davis, *Should Viatical Settlements Be Considered "Securities" Under The 1933 Securities Act?*, 6 KAN. J.L. & PUB. POL'Y 75, 77 ("[R]egistration requirements lead to significantly higher record keeping and reporting costs . . . ."); Patrick T. Morgan, *Regulation*

disclosure can be time-consuming,[27] particularly in light of the breadth of the proposed disclosure items and the fact-intensive nature of the materiality test involved.[28] These activities could turn out to be highly disruptive to business operations by significantly distracting management from concentrating on running the company's business. Notably, these costs include not only the actual analysis, but also the training required to interpret the accounting, financial, and economic data. Such costs may even exceed the benefits of disclosure, especially as the SEC systematically tends to over-compel disclosure—that is, insist on information that the market does not consider material (or worth the cost of production).[29]

B. The Objective of Timely Disclosure

Many commentators have suggested that it is not enough for securities-related disclosure to be of high quality; it must also be timely. For example, Marc Steinberg and Robin Goldman have claimed that, "shareholders and the financial

FD: Leveling the Playing Field for Some But Not for Others, 66 MO. L. REV. 959, 963-64 (noting the costs of information retrieval, processing, and verification costs).

[27] The SEC estimates that the issuer will incur, on average, 430 burden hours per Form 10-K filing (http://www.sec.gov/about/forms/form10-k.pdf), thirty-four burden hours per Form 10-Q filing, (http://www.sec.gov/about/forms/form10-q.pdf), and one and a quarter burden hours per Form 8-K filing (http://www.sec.gov/about/forms/form8-k.pdf) (The burden hours estimates appear in a box on the top right-hand corner of the first page of each form.). These estimates appear to exclude the burden hours incurred by the issuer's legal counsel. With respect to Form 8-K, the estimates may not have accounted for the hours incurred prior to the drafting of the form, i.e., detecting the triggering event and determining whether a report is necessary. *See infra* Part V.A.1.

[28] It is important to note that the particular steps and timing varied depending on the individual company, and not all companies appear to be at the same level of technological sophistication and staffing for preparing reports.

[29] Paul Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1092 (1995). *See also* Morgan, *supra* note 26, at 963-64.

markets are entitled to prompt disclosure. Delay, however short, can have catastrophic consequences."[30] The SEC itself has noted "the information included in the [periodic] reports often is stale by the time the reports are filed,"[31] and has proposed faster disclosure.[32] Some commentators have gone further and suggested that nothing short of real-time data[33] will satisfy the information demand of financial markets. The "periodic" system, according to such commentators, is not adequately meeting these demands.[34]

1. The Benefits of Timely Disclosure

The advantages to timely disclosure substantially overlap with those of quality disclosure. Specifically, timely disclosure is associated with the following advantages: (1) encouraging investors to invest more by providing them with the necessary securities-related information; (2) contributing to a more efficient allocation of resources; and (3) protecting consumers in a vulnerable marketplace.

First, timely disclosure, as many have suggested, encourages investors by satisfying the informational needs of

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[30] Marc I. Steinberg & Robin M. Goldman, *Issuer Affirmative Disclosure Obligations—An Analytical Framework For Merger Negotiations, Soft Information, and Bad News*, 46 MD. L. REV. 923, 953 (1987).

[31] Proposed Rule on Acceleration of Periodic Reports, *supra* note 3. *See also* Manuel F. Cohen, SEC Chairman, Address to Baltimore Security Analysts Society (Jan. 6, 1969), *in* [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,652, at 83,420 (stating that "the nature and timing of the [periodic] reports prevent them from serving as an adequate medium for the rapid and widespread dissemination of current material information to the investing public.")

[32] *See* Rule on Acceleration of Periodic Reports, *supra* note 4.

[33] *See infra* Parts II.B.1 and III.B.1(a) (discussing the real-time disclosure provisions of Regulation FD and the Sarbanes-Oxley Act, respectively).

[34] *Subcommittee on Securities Holds Hearing on Financial Reporting*, 5 ANDREWS SEC. LITIG. & REG. REP. 6 (Aug. 16, 2000) (citing the testimony of Michael R. Young).

investors.[35] As Professor Steinberg explains, "market integrity and investor confidence call for adverse material information to be publicly disclosed without undue delay .... Prompt disclosure normally is critical, because delay can have catastrophic consequences for investors as well as the integrity of the financial markets."[36] In this context, the SEC has recognized the informational benefits of mandating prompter disclosures recently in its final release on accelerating the periodic report filing dates:

> Shortening the due dates for quarterly, annual and transition reports . . . will accelerate the delivery of information to investors and the capital markets, enabling them to make more informed investment and valuation decisions more quickly. While quarterly and annual reports at present generally reflect historical information, a lengthy delay before that information becomes available makes the information less valuable to investors.[37]

Second, delayed disclosure arguably distorts the efficiency of the capital markets.[38] That is, stock prices are less often "correct" because the information they are responding to is

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[35] *See, e.g.*, Steven Wallman, *The Future of Accounting and Financial Reporting Part II*, 10:2 ACCT. HORIZONS 138 (June 1996) ("Today's annual and even quarterly reports . . . do not capture and communicate material developments in sufficient time to meet the markets information needs. Product cycles have shortened, risk management practices have improved and are more prevalent, and products and whole companies become obsolete much more quickly now than ever before. It is hard to obtain a good picture of anything that is moving so quickly and changing so often when only snapshots are taken at relatively long intervals.")

[36] Marc I. Steinberg, *Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis*, 22 U. PA. J. INT'L ECON. L. 635, 661 (2001).

[37] Rule on Acceleration of Periodic Reports, *supra* note 4.

[38] *See* Rule on Acceleration of Periodic Reports, *supra* note 4 (stating that the purpose of the acceleration of periodic report filing deadlines is "to promote greater timeliness and accessibility of this information so that investors can more easily make informed investment and voting decisions. Informed investor decisions generally promote market efficiency and capital formation").

more often out-of-date. Consequently, the economy will not be allocating its resources most efficiently, which implies less accurate valuation and pricing. For example, a company may choose to temporarily suppress bad news in order to borrow more money, or raise more money from the public through issuance of stock, than an efficient market would otherwise permit if all material facts were disclosed in a timely manner.

Third, and perhaps most notably, timely disclosure is said to protect investors by reducing the opportunities for deception and manipulation. For instance, some have suggested that delayed release of financial data encourages earnings manipulation, that "companies coach analysts to reach conclusions concerning the company's earnings, and then companies come forth with earnings that slightly beat these estimates."[39] Given this problem, the SEC has used simultaneous or "real-time" disclosure under Regulation FD[40] as a weapon against selective disclosure and insider trading.[41] Regulation FD requires the issuer to immediately

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[39] *Adapting a 1930s Financial Reporting Model to the 21st Century: Hearing Before the Subcomm. on Securities of the Senate Comm. On Banking, Housing, and Urban Affairs*, 106th Cong. (2000) (testimony of Peter J. Wallison, Resident Fellow, American Enterprise Institute).

[40] On August 15, 2000, the SEC adopted a new rule, Regulation FD (Fair Disclosure), to combat selective disclosure. Selective disclosure occurs when issuers release material nonpublic information about a company to selected persons, such as securities analysts or institutional investors, before disclosing the information to the general public. Regulation FD requires that an issuer disclose material information publicly and not selectively if the disclosure is intentional. The company may make the required disclosure by filing the information with the SEC, or through another method intended to reach the public on a broad, nonexclusionary basis, such as a press release. When selective disclosure of material information is made unintentionally, the company must publicly disclose the information promptly thereafter. Regulation FD, 17 C.F.R. § 243.100-.103 (2001); Selective Disclosure and Insider Trading, 17 C.F.R. pts. 240, 243, 249 (2000).

[41] The paradigm case of insider trading arises when a corporate insider trades (buys or sells) shares of his company using material, nonpublic information obtained through the insider's corporate position. The insider

disseminate any material information disclosed to securities market professionals, preventing analysts from taking advantage (for themselves or for their firms' clients) of their priority access to particular information that may have a bearing on the stock price. As such, "real-time" disclosure under Regulation FD is said to "level the playing field" between insiders and the public.[42]

2. The Costs of Timely Disclosure

Mandating real-time disclosure, like mandating accurate and complete disclosure, comes at a high price. Under a real-time disclosure regime, general counsel and members of senior management of companies would be required to continuously monitor and evaluate all corporate events on a real-time basis to assess their disclosure impact. A related concern is that it is unfair to subject reporting companies to increased exposure to costly listing-related litigation.[43] Not only will companies be liable for incorrect judgments, but they will also be liable for minor delays of a day or two while management and counsel determine whether disclosure is necessary and draft the appropriate disclosure.

Another cost associated with the acceleration of disclosure is the risk of premature disclosures—that is, disclosure of information before it is ripe. It is well settled that premature disclosure of material business developments can, in some instances, cause severe economic harm to the business and the investors, thereby outweighing the benefits of immediate disclosure.[44] For example, given the delicate

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exploits his informational advantage (a corporate asset) at the expense of the company's shareholders or others who deal in the company's stock.

[42] *See* Robert N. Sobol, *Regulation FD: Mandates on Managing Disclosure*, LEGAL INTELLIGENCER, June 13, 2001, at 1 (commenting that Regulation FD's requirement of disclosure would "level the playing field among investors"); Morgan, *supra* note 26, at 963-64.

[43] *See* Davis, *supra* note 26, at 77 ("[R]egistration requirements lead to . . . greater potential liability for misrepresentations to investors.").

[44] *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1070 (1990) (noting that "it is well settled that premature

nature of contract negotiations, to require disclosure of interim non-binding agreements, particularly in the merger and acquisition context, could cause the negotiations to fall apart, destroying deals that otherwise could prove beneficial to the company and its shareholders. In such situations, the risk of harm to the company (and indirectly to its investors) from premature disclosure, as critics of real-time disclosure argue, may justify deferring reporting.

A further objection to real-time disclosure is the need to defer generally to business judgment as to the timing of disclosures. That is, corporate management should arguably retain some flexibility to temporarily refrain from disclosing information to the public, even those types of information which would be deemed material. As the American Stock Exchange ("AMEX") has noted in its company guide, immediate disclosure of some events may prejudice the ability of a company to advance its corporate objectives:

> [C]ircumstances may occasionally arise where disclosure would prejudice a company's ability to achieve a valid corporate objective. Public disclosure of a plan to acquire certain real estate, for example, could result in an increase in the company's cost of the desired acquisition or could prevent the company from carrying out the plan at all.[45]

Accordingly, AMEX permits listed companies to defer an announcement of an event if "the unfavorable result to the company outweighs the undesirable consequences of non-disclosure."[46]

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disclosure of merger discussions may thwart [a] merger"); Greenfield v. Heublein, Inc., 742 F.2d 751, 756-57 (3d Cir. 1984) (premature disclosure can "seriously inhibit . . . acquisitive ventures"), *cert. denied*, 469 U.S. 1215 (1985); Staffin v. Greenberg, 672 F.2d 1196, 1204-07 (3d Cir. 1982) ("[D]isclosure of preliminary merger discussions would . . . do more harm than good to shareholders . . . .").

[45] AMERICAN STOCK EXCHANGE COMPANY GUIDE (LISTING STANDARDS AND REQUIREMENTS) §402.

[46] *Id.*

III. REGULATORY EFFORTS TO ENHANCE QUALITY AND TIMELINESS

While the two objectives individually entail both costs and benefits, general consensus suggests that mandating high quality and prompt disclosure is, on balance, beneficial.[47] Such belief is reflected uniformly in federal securities regulation, and particularly, in scores of recent congressional and SEC initiatives. The following discussion begins by providing an overview of the efforts of regulators to ensure quality and timeliness in corporate disclosure. It then addresses recent far-reaching efforts of the SEC and Congress, including the Sarbanes-Oxley Act and Form 8-K amendments, to update and enhance the framework.

A. Existing Regulation

1. Reporting Requirements Under the Exchange Act

Public companies are subject to ongoing reporting requirements, and there is a strong public policy in favor of doing so.[48] The SEC established a system of issuer registration in the Securities Act of 1933.[49] Though the Securities Act was effective in regulating initial distributions of securities,[50] its limited scope prevented it from compelling disclosure on a continual basis. Congress remedied these concerns in sections 12 and 13 of the Exchange Act by

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[47] A large and growing body of literature has developed challenging the need for mandatory disclosure. Notably, Professor Merritt Fox has argued that "[d]isclosure is not necessary to protect investors against either unfair prices or risk." The argument is based in part on the assumption that investors can protect themselves through portfolio diversification. However, Professor Fox concedes that "[h]igh quality issuer disclosure has substantial value all of the time." Fox, *supra* note 20, at 907, 918.

[48] *See supra* Parts II.A.1, II.B.1.

[49] Securities Act of 1933 § 12(a), 15 U.S.C. § 77a (2000).

[50] *Id.* at § 6.

establishing a system of continuing disclosure of information about companies choosing to issue securities to the public. Section 12 ("Registration Requirements for Securities") requires companies to register with the SEC any security listed on a national securities exchange in much the same way that companies register initial offerings under the Securities Act.[51] Section 13 ("Periodical and Other Reports") requires that the information companies file pursuant to section 12 be "reasonably current."[52]

As part of the Exchange Act reporting requirements, public corporations must produce two periodic reports setting forth the status of their operations and financial condition. The Exchange Act requires issuers to file annual reports on Form 10-K,[53] which must contain, among other things, audited financial statements, disclosures concerning legal proceedings, and a management discussion and analysis ("MD&A") section. The MD&A section must discuss "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[54] The Exchange Act also requires issuers to file quarterly reports on Form 10-Q.[55] Form 10-Q reports contain the same MD&A discussion along with other enumerated disclosures.[56]

In addition to the two periodic reports, public issuers must file current reports on Form 8-K[57] when certain

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[51] Securities Exchange Act of 1934, 15 U.S.C. § 12 (2000).

[52] *Id.* at § 13.

[53] Form 10-K, 17 C.F.R. § 249.310 (2003), *available at* http://www.sec.gov/divisions/corpfin/forms/10k.htm (last visited Apr. 14, 2003).

[54] 17 C.F.R. § 229.303(a)(3)(ii) (2003).

[55] Form 10-Q, 17 C.F.R. § 249.308a (2003), *available at* http://www.sec.gov/divisions/corpfin/forms/10q.htm (last visited Apr. 14, 2003).

[56] *Id.*

[57] Form 8-K, 17 C.F.R. § 249.308 (2003), *available at* http://www.sec.gov/divisions/corpfin/forms/8-k.htm (last visited Apr. 14, 2003).

significant events occur. As originally adopted by the SEC in 1936, Form 8-K reports could be filed as late as ten days after the end of the month in which the event requiring disclosure occurred.[58] This created the possibility that a company would not have to report a Form 8-K event occurring on the first day of a month until forty days later.

Since 1936, Form 8-K has undergone a series of substantive changes. In 1977, the SEC made significant amendments to create the general structure of the form that exists today, including filing deadlines that require reporting of some corporate events within five business or fifteen calendar days after their occurrence, depending on the nature of the event.[59] In recent years, the SEC has amended Form 8-K at various times to add or delete items.[60]

Form 8-K currently consists of ten disclosure items.[61] Six of them describe specific events that require a report to be filed. Those events include:

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[58] Exchange Act Release No. 34,925, 1936 SEC LEXIS 391 (Nov. 11, 1936).

[59] Exchange Act Release No. 34,13156, 42 Fed. Reg. 4424 (Jan. 13, 1977).

[60] In 1998, the SEC published proposals to expand Form 8-K disclosure and shorten the filing date in a package of proposed revisions intended to effect comprehensive reform of the Securities Act offering system. Specifically, the SEC proposed to add six disclosure items to Form 8-K and to shorten the Form 8-K filing deadline to five calendar days for some items and one business day for other items. The proposed disclosure items included the following: (1) timely disclosure of annual and quarterly earnings results of domestic companies; (2) material modifications to the rights of security holders; (3) departure of a chief executive officer, president, chief financial officer or chief operating officer; (4) material defaults on senior securities; (5) notice from an auditor that the company no longer may rely on a prior audit report; and (6) corporate name changes. The Regulation of Securities Offerings, Securities Act Release No. 33,7606A, 63 Fed. Reg. 67,174 (Dec. 4, 1998). Recently, the SEC proposed adding a tenth item to Form 8-K that would require prompt disclosure by a company on Form 8-K of transactions by its officers and directors in the company's securities. Form 8-K Disclosure of Certain Management Transactions, Securities Act Release No. 33,8090, 67 Fed. Reg. 19,914 (Apr. 23, 2002).

[61] *See* Form 8-K, *supra* note 57.

- A change in control of the company;
- The company's acquisition or disposition of a significant amount of assets;
- The company's bankruptcy or receivership;
- A change in the company's certifying accountant;
- The resignation of a company director; and
- A change in the company's fiscal year.

A seventh item requires companies to furnish exhibits and to list any financial statements and pro forma financial information included as part of Form 8-K in connection with a business acquisition. Another item permits companies to disclose voluntarily events that they deem to be important to their shareholders. The ninth item permits companies to use Form 8-K as a non-exclusive method to satisfy their Regulation FD disclosure requirements.[62] The tenth item requires companies to describe the nature of any amendments to, or waivers of, any provision of its code of ethics.

2. Consequences of Noncompliance

An issuer faces severe penalties if it is late in filing its reports. For example, a late issuer loses availability of Form S-3 short-form registration for at least one year from the date of the late filing.[63] For some companies, grave consequences flow from the loss of Form S-3, which affords them the benefits of incorporation by reference and quick access to the capital markets through "shelf registration."[64]

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[62] *See supra* note 40 and accompanying text for discussion of Regulation FD.

[63] Form S-3, 17 C.F.R. § 239.13 (2003). A current version of Form S-3 is available at: http://www.sec.gov/about/forms/forms-3.pdf (last visited Apr. 14, 2003).

[64] *Id.* According to the SEC's definition:

> [A shelf registration] allows a company to prepare its registration materials but then delay making an offering of new securities for up to two years. The company can keep the registration "on the shelf" and go to the market quickly as the need for new capital arises or as the market conditions become favorable for an offering.

Being late also could render Securities Act Rule 144 temporarily unavailable for security holders' resales of restricted and control securities, and make new filings on Form S-8 temporarily unavailable for resales of employee benefit plan securities.[65]

3. "Duty to Update"

Save for the required filings discussed above, the timing of disclosure remains primarily within the issuer's discretion.[66] Under the current statutory framework, public companies are under no affirmative duty to disclose material nonpublic information during the interval between the filing of periodic reports with the SEC.[67] In the absence of a

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SEC, "Fast Answer: What is a Shelf Registration?" *available at* http://sec.broaddaylight.com/sec/index.html.

[65] Securities Act Rule 144, 17 C.F.R. § 230.144 (2003) (requiring that for such a resale to be valid, the issuer of the securities must have made all filings required under the Exchange Act during the preceding 12 months). *See* Form S-8, 17 C.F.R. § 239.16b (2003) (requiring that an issuer be current in its reporting for the last 12 calendar months or such shorter period that the issuer was required to file such reports and materials). A company late in its filing would lose Rule 144 eligibility and eligibility to file a Form S-8 during the time that the company was not current in its reporting. For a critique of this liability system, see Fox, *supra* note 20, at 904-905 (arguing that "we should establish a system of liability that creates incentives for established public issuers to provide disclosure in their periodic filings that is as high quality as they traditionally provided at the time of a registered public offering prior to short form and shelf registration").

[66] For a general discussion of the duty to update, see Marc I. Steinberg, *Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis*, 22 U. PA. J. INT'L ECON. L. 635 (2001).

[67] *See* Greenfield v. Heublein, Inc., 742 F.2d 751, 756 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985); Texas Partners v. Conrock Co., 685 F.2d 1116, 1120 (9th Cir. 1982); South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co., 669 F.2d 1265, 1271, 1273 (9th Cir. 1982). However, once a public company speaks, whether in required periodic reporting or in a voluntary public statement, the company has a duty to confirm that its disclosure is materially accurate and does not omit any material information. In addition, if a public company or its investors are purchasing or selling its own securities, this triggers an immediate duty to

triggering event requiring prompt disclosure,[68] disclosure could be deferred if it served a legitimate business purpose.[69] Similarly, disclosure could be delayed if the information was not yet ripe (i.e., had not yet become specific enough to give management confidence in its accuracy).[70]

Apart from the SEC reporting obligations, national stock exchanges impose certain disclosure rules, which reflect a conscious effort to address the affirmative publicity duty.[71] The rules are fairly vague, tending to permit nondisclosure

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disclose all material nonpublic information. In its 1976 *TSC Industries v. Northway, Inc.* decision, the United States Supreme Court found that company information is material if there is a substantial likelihood that a reasonable shareholder would consider it important in making investment decisions. The Court explained further that nonpublic corporate information is material if it "significantly altered the "total mix" of information available to shareholders." 426 U.S. 438, 449. In *Basic Inc. v. Levinson*, decided in 1988, the Supreme Court specifically applied the *TSC Industries* standard to preliminary merger discussions. In measuring whether information regarding a given set of merger negotiations is material, a company must evaluate the facts surrounding the negotiations to balance the probability that the merger will occur and the magnitude of the impact that the merger would have on the company as a whole. 485 U.S. 224 (1988). *But see* Backman v. Polaroid Corp., 910 F.2d 10 (1990) (excusing a company's failure to disclose material information where the information was made credibly available to the market by other sources).

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

[69] *See, e.g.*, Reiss v. Pan Am. World Airways, Inc., 711 F.2d 11 (2d Cir. 1983).

[70] *See* Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 519 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973).

[71] NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 202.05-.06 (1996) ("A listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities . . . unfavorable news should be reported as promptly and candidly as favorable news."); AMERICAN STOCK EXCHANGE COMPANY GUIDE (LISTING STANDARDS AND REQUIREMENTS) § 402 ("Immediate disclosure should be made of [material] information about a company's affairs or about events or conditions in the market for its securities . . ."); NATIONAL ASSOCIATION OF SECURITIES DEALERS MANUAL § IM-4120-1 (Issuers are required to "disclose promptly to the public . . . any material information which would reasonably be expected to affect the value of their securities or influence investors' decisions.").

when there is some business justification. For example, both AMEX and NASDAQ permit nondisclosure when immediate disclosure would prejudice the ability of the listed company to pursue its "corporate objectives," and the New York Stock Exchange ("NYSE") permits delayed disclosure in light of a balancing between present and future shareholder interests. However, these rules are not enforced to the same extent as those of the SEC.[72] The exchanges and NASDAQ aggressively compete for legitimate issuers, which makes the likelihood of de-listing, or any other significant penalty, for a violation of the disclosure rules minimal.[73] The courts have likewise shown reluctance in allowing for third-party enforcement of these rules.[74]

B. Recent Regulatory Efforts

The quality-timeliness tradeoff is a particularly timely issue in light of recent regulatory efforts. In response to the well-publicized corporate governance fallouts in 2002,[75] the SEC has proposed and adopted a series of changes to securities law aimed at producing both higher quality and more rapid disclosures.

1. Sarbanes-Oxley-Related Reforms

In the aftermath of the Enron and WorldCom collapses, as well as other highly-publicized corporate debacles, which have led to an unprecedented level of attention paid to corporate governance, financial disclosure, and auditing

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[72] *See* Robert B. Robbins & Steven C. Wydler, *The Effect of Stock Exchange Rules on Corporate Disclosure Obligations*, 29 REV. SEC. & COMMOD. REG. 211 (1996).

[73] *Id.*

[74] Courts generally have not allowed investors to invoke violations of the listing standards as a basis for a private right of action. *See, e.g.*, State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 851-53 (2d Cir. 1981).

[75] *See, e.g.*, *Accounting for Change*, THE ECONOMIST, June 29, 2002; Kurt Eichenwald and Simon Romero *Turmoil at WorldCom: The Decision-Making*, N.Y. TIMES, June 27, 2002, at A1.

issues, President Bush signed into law the Public Company Accounting Reform and Investor Protection Act of 2002 (also referred to as the Sarbanes-Oxley Act of 2002 and referred to herein as the "Sarbanes-Oxley Act").[76] One of the main aims of the Sarbanes-Oxley Act is to improve public companies' disclosure of financial information.[77] In furtherance of this goal, the Sarbanes-Oxley Act has required the SEC, among other things, to promulgate new rules improving the quality and timeliness of disclosure.

i. Real-Time Disclosure

One of the most far-reaching regulations pertaining to the timeliness of disclosures is in section 409's mandate of real-time public disclosures. Specifically, section 409 added new section 13(*l*) to the Exchange Act, requiring public companies to disclose "on a *rapid and current basis* such additional information concerning material changes in the financial condition or operations of the issuer . . . as the [SEC] determines, by rule, is necessary or useful for the protection of investors and in the public interest."[78] The SEC has responded to this congressional mandate by implementing various rules for speedier disclosures. These include the acceleration of the filing dates for Forms 10-K,[79] 10-Q,[80] and 8-K.[81]

ii. CEO/CFO Certifications

In addition to the real-time disclosure provision, the Sarbanes-Oxley Act contains two provisions requiring certification by Chief Executive Officers (CEOs) and Chief

[76] *See supra* note 7.

[77] Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 33,8145, 2002 SEC LEXIS 2812 (Nov. 5, 2002) ("Among its many goals, the Sarbanes-Oxley Act seeks to enhance the financial disclosures of public companies.").

[78] *See* Sarbanes-Oxley Act, *supra* note 7 (emphasis added).

[79] *See* Rule on Acceleration of Periodic Reports, *supra* note 4.

[80] *Id.*

[81] *See* Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3.

Financial Officers (CFOs) of periodic reports filed with the SEC. Section 906 of the Sarbanes-Oxley Act requires CEOs and CFOs to certify in each periodic report containing financial statements that:

- the report fully complies with the requirements of sections 13(a) and 15(d) of the Exchange Act, and
- the information contained in the report fairly presents, in all material respects, the company's financial condition and results of operations.[82]

False certification of financial information carries stiff fines. Specifically, certifying officers of domestic public companies will face penalties for false certification of $1,000,000 and/or up to 10 years imprisonment if the violation was "knowing" and $5,000,000 and/or up to 20 years imprisonment if the violation was "willful."[83]

In addition to the section 906 certification, section 302 of the Sarbanes-Oxley Act directs the SEC to adopt rules, which it did on August 29, 2002,[84] requiring CEOs and CFOs to certify in each annual and quarterly report filed with the SEC that:

- they have reviewed the report;
- based on their knowledge,
  - the report does not contain any material misstatements or omissions and
  - the financial statements and other financial information included in the report fairly present in all material respects the company's financial condition and results of operations; and
- they have designed and reviewed the effectiveness of internal controls to ensure that they receive material information and they have disclosed to the audit

[82] Sarbanes-Oxley Act § 906, *supra* note 7.

[83] *Id.*

[84] Certification of Disclosure in Companies' Quarterly and Annual Reports, 17 C.F.R. pts. 228, 229, 232, 240, 249, 270, 274 (Aug. 29, 2002) [hereinafter Rule on CEO/CFO Certification].

committee any fraud and all significant deficiencies in the design or operation of the internal controls.[85]

In promulgating its certification rules pursuant to Congress' directive,[86] the SEC primarily justifies its actions on the need to "ensure that issuers maintain sufficient internal reporting controls and procedures to provide reasonable assurance that they can record, process, summarize and report the information that is required in all Exchange Act reports."[87] According to the SEC, such certifications can also improve the speed of information flow: "The required evaluation help[s] to identify potential weaknesses and deficiencies in advance of a system breakdown, thereby ensuring the *continuous, orderly and timely* flow of information within the company and, ultimately, to investors and the marketplace."[88]

iii. Disclosure of Off-Balance Sheet Arrangements

On January 27, 2003, the SEC adopted rules implementing section 401(a) of the Sarbanes-Oxley Act, embodied in new section 13(j) of the Exchange Act.[89] The rules require additional disclosure in the MD&A section of a company's disclosure documents, by lowering the threshold that triggers disclosure of off-balance sheet arrangements – requiring disclosure relating to off-balance sheet arrangements be set apart in a designated section of MD&A, and (except in the case of small business issuers) disclosure of aggregate contractual obligations and contingent liabilities and commitments.

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[85] Sarbanes-Oxley Act § 302, *supra* note 7.

[86] *Id.*

[87] Rule on CEO/CFO Certification, *supra* note 84.

[88] *Id.* (emphasis added).

[89] Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, 17 C.F.R. pts. 228, 229, 249 (Jan. 27, 2003) [hereinafter Rule on MD&A about Off-Balance Sheet Arrangements].

These rules address a wide variety of arrangements. An "off-balance sheet arrangement" is defined as any transaction, agreement or other contractual arrangement to which an entity that is not consolidated with the reporting company is a party, under which the reporting company, (whether or not a party to the arrangement) has, or may have:

- any obligation under a direct or indirect guarantee or similar arrangement;
- a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement;
- derivatives, to the extent that the fair value thereof is not fully reflected as a liability or asset in the financial statements; or
- any obligation or liability, including a contingent obligation or liability, to the extent that it is not fully reflected in the financial statements (excluding the footnotes).[90]

These rules require the disclosure of the facts and circumstances that provide investors with a clear understanding of the reporting company's business activities, financial arrangements and financial statements. In order to filter out disclosure of insignificant details, the rules require disclosure of enumerated items only to the extent necessary to an understanding of the effect of the off-balance sheet arrangements on the company's financial condition, changes in financial condition, revenues and expenses, results of operations, liquidity, capital expenditures and capital resources. Under the new rules, a reporting company is required to disclose the following:

- the nature and business purpose of the off-balance sheet arrangements;
- the significant terms and conditions of the arrangements;
- the nature and amount of the total assets and total obligations and liabilities (including contingent

[90] *Id.*

obligations and liabilities) of an entity in which off-balance sheet activities are conducted; and

- management's analysis of
  - the material effects of the off-balance sheet arrangements and resulting obligations and liabilities on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures and capital resources;
  - the degree to which the company relies on off-balance sheet arrangements for its liquidity and capital resources, or market risk or credit risk support of other benefits; and
  - the effects of a termination or material reduction in the benefits of the off-balance sheet arrangements. The proposed rules would apply to foreign private issuers that file annual reports on Form 20-F or on Form 40-F but would not apply to Form 6-K reports.[91]

According to the SEC, these rules are intended to enhance the quality of the disclosure. As the SEC states in the cost-benefit analysis of the final rule, "improvement in the quality of information in these areas is necessary for investors to better understand a company's current and future financial position and current and future sources of liquidity."[92]

iv. Non-GAAP Financial Measures Disclosure

On January 22, 2003, the SEC adopted rules implementing section 401(b) of the Sarbanes-Oxley Act[93] which requires companies to disclose or release information that is derived on the basis of methodologies other than in accordance with GAAP.[94] The SEC adopted Regulation G,

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[91] *Id.*

[92] *Id.*

[93] Sarbanes-Oxley Act § 401(b), *supra* note 7.

[94] Conditions for Use of Non-GAAP Financial Measures, 17 C.F.R. pts. 228, 229, 244, 249 (Jan. 22, 2003).

which applies whenever a reporting company publicly discloses or releases material information that includes a non-GAAP financial measure, and an amendment to Form 8-K to add item 1.04 as to the disclosure of results of operations and financial condition. Regulation G applies to any entity that is required to file reports pursuant to sections 13(a) and 15(d) of the Exchange Act, other than a registered investment company. It requires a reporting company to provide the following information as part of the disclosure or release of non-GAAP financial information:

- a presentation of the most comparable financial measure calculated and presented in accordance with GAAP; and
- a reconciliation (by schedule or other clearly understandable method) which shall be quantitative for historic measures and quantitative, to the extent available without unreasonable efforts, for prospective measures, of the differences between the non-GAAP financial measure presented and the comparable financial measure or measures calculated and presented in accordance with GAAP.[95]

According to the SEC, these rules are intended "to provide the securities markets with additional information to more accurately evaluate companies' securities and, in turn, result in a more accurate pricing of securities."[96]

2. Acceleration of Periodic Report Filing Dates

On September 5, 2002, the SEC adopted rules to shorten the filing deadlines of quarterly and annual reports under the Exchange Act for large seasoned public companies.[97]

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[95] *Id.*

[96] *Id.*

[97] The accelerated deadlines only apply to "accelerated filers." Under the final rules, the term "accelerated filer" is defined as having met the following conditions as of the end of its fiscal year: "(i) the aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer is $75 million or more; (ii) the issuer has been subject to the requirements of Section 13(a) or 15(d) of the Exchange Act

Prior to these amendments, companies were required to file their annual report on Form 10-K within ninety days following the year's end, and quarterly reports on Form 10-Q within forty-five days following the quarter's end. The new rules require companies to file their annual reports on Form 10-K within the same timeframe for year one (fiscal year ending 2003), but accelerate the deadlines to seventy-five days for year two (fiscal year ending 2004), and sixty days for year three (fiscal year ending 2005) and thereafter. The quarterly report (Form 10-Q) deadline will remain forty-five days for year one, and change to forty days for year two and thirty-five days for year three and thereafter.[98] According to the SEC, these amendments are intended to improve the timeliness and accessibility of Exchange Act reports to investors and the financial markets at large.[99]

3. Additional Form 8-K Disclosure Requirements and Acceleration of Form 8-K Filing Date

Having already shortened the filing timeframe for periodic reports (Forms 10-K and 10-Q), the SEC has proposed shortening the filing timeframe for current reports (Form 8-K) as well. "The [SEC] believes that markets and investors need more timely access to a greater range of

(15 U.S.C. §§ 78m or 78o(d)) for a period of at least twelve calendar months; (iii) the issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and (iv) the issuer is not eligible to use Forms 10-KSB and 10-QSB (§ 249.310b and § 249.308(b)) for its annual and quarterly reports." Nearly half of all publicly traded companies are excluded from the accelerated deadline obligations. Furthermore, once an issuer becomes an accelerated filer, it will remain an accelerated filer unless the issuer becomes eligible to use Forms 10-KSB and 10-QSB for its annual and quarterly reports. In that case, the issuer will not become an accelerated filer again unless it subsequently meets the conditions. *See* Rule on Acceleration of Periodic Reports, *supra* note 4.

[98] *Id.*

[99] *Id.*

important information concerning public companies than what is required by the existing reporting system."[100]

Presently, a limited number of corporate items are required to be disclosed pursuant to the filing of a Form 8-K, which is required to be filed within five to fifteen days after the occurrence of the item.[101] The new rules propose that a Form 8-K be required to be filed no later than the second business day following the occurrence of the following:

- Entry into a material agreement outside the ordinary course of business;
- Termination of a material agreement outside the ordinary course of business;
- Termination or reduction of a business relationship with a customer that constitutes a specified amount of the company's revenues;
- Creation of a material financial obligation, whether direct or contingent;
- Events triggering a material financial obligation, whether direct or contingent;
- Exit activities, including material write-offs and restructuring charges;
- Any material charge of impairment to assets;
- A change in a rating agency decision, issuance of a "credit watch" or a change in company outlook;
- Notice of delisting or failure to comply with the listing standards of an exchange;
- Conclusion or notice that security holders should not rely on previously issued financial statements or a related audit report;
- Creation of a material limitation, restriction or prohibition regarding the company's employee benefit, retirement and stock ownership plans;
- Unregistered sales of equity securities by the company;
- Material modifications to rights of holders of the company's securities;

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[100] Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3.

[101] *See* Form 8-K, *supra* note 57.

- A director's departure or a director's election other than by security holders at an annual meeting, or the appointment or departure of a principal officer; and
- Any material amendment to the company's articles of incorporation or bylaws.[102]

The proposed rules dramatically broaden the number and type of reportable items, thereby requiring a careful, real-time assessment of corporate events that were traditionally not considered significantly relevant to disclose.

IV. THE QUALITY-TIMELINESS TRADEOFF

As the above survey of the regulatory framework suggests, an issuer's disclosure duties under the new disclosure regime have become increasingly more continuous and comprehensive. This trend brings to the forefront the tensions between two competing concerns in corporate disclosures: quality and timeliness.

This section draws upon one of the most ambitious SEC initiatives in recent years, namely, the Form 8-K proposals,[103] to illustrate the tradeoff between quality and timeliness. The analysis is organized according to the practical steps involved in preparing a Form 8-K. These steps include: (1) detection of the event and assessment of the need for a report, (2) information gathering, (3) analysis of the gathered information, and (4) final review and EDGARization.[104] The objective of the analysis is to show that, in each stage of the reporting process, efforts to achieve

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[102] Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3. Compare these items to those considerably less numerous in current Form 8-K, *supra* note 57. The SEC also is considering a possible addition of a new Form 8-K disclosure item regarding a material change in a company's accounting policy or estimate. *See* Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3, at n.45.

[103] *See* Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3. *See also supra* Part III.B.3.

[104] This is not to suggest that all companies necessarily follow these steps and in this order. Indeed, there currently are no best practices for report preparation. *See* Rule on Acceleration of Periodic Reports, *supra* note 4, at n.150.

both objectives concurrently often result in compromises in one or both objectives.[105]

A. Stage 1: Detecting the Event and Assessing the Need for a Report

The process of a Form 8-K report filing usually begins with non-executive employees notifying management that an event may occur or has occurred that could require the filing of a Form 8-K. Once management is notified, it must assess whether filing a Form 8-K is required.

Assessing the need for a report may require considerable time as it involves difficult judgments as to materiality. The proposed rules require the filing of a Form 8-K with respect to a number of events based on whether they are "material" to the issuer. In particular, nine of the fifteen items requiring disclosure in the proposed Form 8-K contain the word "material." These include, for example, "events triggering a direct or contingent financial obligation that is *material* to the company," "exit activities including *material* write-offs and restructuring charges," and "any *material* impairment."[106] Moreover, the triggering of the first two items are dependent on whether they occurred outside the ill-defined scope of "the ordinary course of business."[107]

Companies and their legal counsel may have great difficulty in determining whether and when materiality thresholds have been passed. The difficulty stems, in large part, from the lack of guidance with respect to what is considered material. The SEC has not defined "material," but instead relies on formulations developed by courts—formulations that are imprecise and fluid.[108] The SEC has stated that the determination of a material event depends on

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[105] An important caveat to this analysis is that the proposals contain a number of novel features. As such, their implications may be fully assessed only upon their implementation.

[106] *See* Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3 (emphasis added).

[107] *Id.*

[108] *Id.*

"the specific facts and circumstances of any given case."[109] As the SEC has noted in other contexts, the "onerous duty of making materiality decisions," is such that it cannot be properly discharged without considering "*all* of the relevant circumstances."[110] As one law firm put it, "the proposed two business day deadline will in many cases prove impossible to satisfy, particularly in light of the breadth of the proposed disclosure items and the fact-intensive nature of the materiality tests involved."[111]

Judgments about materiality are extremely difficult because companies must consider both "quantitative" and "qualitative" factors. Accordingly, it is hard to predict in advance what information the market will treat as material, and such judgments are easy to second-guess in hindsight. For example, the materiality considerations are particularly complicated with regard to contracts. Under the proposed rule,[112] whenever a contract is created or terminated, management must determine the materiality of the contract. This can be difficult given that a contract may be qualitatively material even when it is quantitatively insignificant. Absent further guidance from the SEC, management will be left to their own devices to determine whether a particular contract is material at the time it is signed, without the benefit of waiting to see its actual consequences.

The continuously changing nature of certain businesses further complicates the assessment of the need for a report.

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[109] SEC, "Fast Answer: With Regard to Form 8-K, What is a Material Event?," *available at* http://sec.broaddaylight.com/sec/index.html.

[110] Staff Accounting Bulletin No.99, 17 C.F.R. pt. 211 (Aug. 12, 1999). *See also* FASB CONCEPTS STATEMENT No. 2, QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION 131 (1980) ("The predominant view is that materiality judgments can properly be made only by those who have all the facts.").

[111] Comment Letter from Cleary, Gottlieb, Steen & Hamilton, to the SEC (Aug. 26, 2002), *available at* http://www.sec.gov/rules/proposed/s72202/cleary1.htm [hereinafter Comments of Cleary Gottlieb].

[112] *See* Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3. *See also infra* Part III.B.3.

That is, an event may be immaterial for a company at point X, but, due to changes in the scope, model, or strategy of its business, material at a later point Y. Suppose, for example, that a movie rental franchise, due to changing market conditions, decides to shift its corporate focus to the retail sale of digital videos imported from overseas. A multi-million dollar video consignment contracted entered into with certain entertainment companies a year ago may no longer be considered material as a result of the change in corporate strategy.

The subjectivity of some of the thresholds for many of the triggering events further exacerbates the problem. For example, Item 1.03 requires disclosure when the company becomes "aware that a termination or reduction of a business relationship meeting the 10% threshold has occurred or will occur."[113] While no disclosure is necessary if the company is in negotiations or discussions with the customer, it will be difficult for an issuer to determine when the negotiation period has ended and when it knows that a termination or reduction "will occur;"[114] nor is it apparent how to conclude the exact time that the company became "aware."[115] It will be even more challenging to determine if a termination or reduction in triggering a Form 8-K filing has occurred when the issuer is not in discussions with the customer. As some commentators have suggested, "any requirement for disclosure of a termination or reduction in business requires much more specificity and objectivity than the Release contains."[116]

Even if issuers do meet the prescribed deadlines, there are risks of significant compromises to the quality of the disclosure. Specifically, the combination of the lack of clarity, the prompt deadlines, and the liability that may

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[113] *See* Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3.

[114] *Id.*

[115] *Id.*

[116] Comment Letter from Joseph A. Grundfest et al., to the SEC (October 3, 2002), *available at* http://www.sec.gov/rules/proposed/s72202/mjhalloran1.htm [hereinafter Comment Letter of Grundfest].

result from failing to report a material event, may create an incentive for companies to provide endless disclosure of arguably immaterial events. That is, without further clarification of what is deemed material, companies may provide disclosure for every conceivably material event in order to avoid liability issues. This "disclosure overload"[117] may make it more difficult for investors to focus on the more important disclosures about significant corporate events.

By masking truly important information, "disclosure overload" can be detrimental to investors. Surveys have shown that five to fifteen minutes is as much time as the average reader spends on an annual report.[118] This implies that the average reader can digest only a fraction of the information in these lengthy documents and may rely mostly on the highlighted information. As one commentator put it, "[t]here may be a large amount of information available, but whether it is helpful or material to investing decisions is certainly arguable. Investors may be 'drowning in information while starving for knowledge.'"[119]

Apart from the problem of "disclosure overload," pushing for speedier disclosure can also compromise the level of uniformity and consistency in how the information is presented. This lack of uniformity makes it more difficult for investors to engage in meaningful comparisons among securities and their issuers. As discussed above, materiality

[117] For a discussion of the problem of information overload in securities regulation, see Laura S. Unger, Rethinking Disclosure in the Information Age: Can There Be Too Much of a Good Thing, Address before the Internet Securities Regulation American Conference Institute (June 26, 2000), *available at* http://www.sec.gov/news/speech/spch387.htm (discussing adverse effects that excess information may have on the securities market).

[118] S. GOLUB & J. KUEPPERS, SUMMARY REPORTING OF FINANCIAL INFORMATION 1 (1983).

[119] Erick D. Prohs, Note, *Periodic Financial Reporting—A Relic of the Past?*, 27 IOWA J. CORP. L. 481, 492 (2002) (quoting *Adapting a 1930s Financial Reporting Model to the 21st Century: Hearing before the Subcomm. on Securities of the Comm. on Banking, Housing, and Urban Affairs*, 106th Cong. (2000) (testimony of Steve M. Samek, Partner, Arthur Andersen)).

judgments are among the most difficult judgments that companies must make when complying with the disclosure rules under the federal securities laws. Because they require subjective assessments of the particular facts facing a particular company, different companies may come to different conclusions when analyzing similar situations. This is especially true when the judgments must be made hastily, with insufficient time to reflect on developments and analyze information. Requiring real-time disclosures based on these judgments subjects companies to second-guessing and will likely result in inconsistent levels of disclosures among public companies.[120] This lack of consistency, in turn, could reduce the ability of investors to make comparisons among different securities, and hence, undermine the securities regulation's key goals of consumer protection, the investors' need for information, and allocative efficiency.[121]

B. Stage 2: Gathering and Preparing the Information

Once management makes the necessary materiality judgments and determines that a report is needed, the next step is typically to collect and prepare the information required to be disclosed. It is important to note here that information is not monolithic; certain types of information are more complex than others. While some kinds of information, such as the text of amendments to the company's charter or bylaws, or the names of elected or departing directors and officers,[122] may be relatively easy to report, other sorts of information, especially certain kinds of financial information, may require more time for preparation. Accordingly, the time required for information

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[120] *See* Comment Letter of Grundfest, *supra* note 116 (arguing that "[i]t is unreasonable to expect issuers to condense these steps into two days without risking . . . widely variable quality of disclosure").

[121] *See supra* Parts II.A, II.B.

[122] However, even these disclosures may be difficult, due to the sheer number of positions covered by the rule and the requirement that the registrant characterize the reasons for the officer changes. *See* Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3.

gathering depends highly on the type of information in question.

At this stage, confidentiality concerns can severely hamper the ability of companies to prepare information promptly. As one registrant explained in its comment letter:

> [E]ven ten business days may be inadequate for the filing of documents which contain sensitive commercial information. Submitting a confidential treatment request requires the company to prepare a proposed version of the contract that redacts sensitive confidential information line-by-line and word-by-word and to provide supporting arguments for each redaction. It can take several days to prepare, review internally and with the other party and file a confidential treatment request and then an additional period of time for the Commission to issue a ruling.[123]

Moreover, prompt disclosure will be especially onerous in situations where the original document or agreement must first be translated into English. Indeed, the translation and proofreading alone can take more than two days to complete.

These difficulties in making prompt disclosure are underscored by the recent experience with accelerated deadlines for filing Form 4,[124] which reports changes of beneficial ownership of securities. In August 2002, the form's deadline was accelerated to two business days from the previous deadline of ten days after the end of the month in which the transaction occurred. Practitioners[125] have found it very difficult to gather the information (such as the type and amount of securities acquired or disposed of),[126] complete the Form 4, and file the Form 4 with the SEC within the Form's two-business-day deadline. "Indeed, the Form 4 disclosures are much simpler and can be filed in a

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[123] Comment Letter of Patrice C. Scatena, Senior Counsel, Corporate Affairs and Treasury Operations, Intel Co., to the SEC (Aug. 26, 2002), *available at* http://www.sec.gov/rules/proposed/s72202/pcscatena1.htm [hereinafter Comment Letter of Intel].

[124] Form 4, 17 C.F.R. § 249.104 (2003), *available at* http://www.sec.gov/about/forms/form4data.pdf. (last visited Apr. 14, 2003).

[125] *See* Comment Letter of Grundfest, *supra* note 116.

[126] *See* Form 4, *supra* note 124.

variety of different ways that give issuers more flexibility than the proposed Form 8-K disclosures."[127]

C. Stage 3: Analyzing the Information

The third major stage in the report preparation process is conducting an analysis of the relevant issues. This stage often requires the management to prepare a draft Form 8-K (possibly including a MD&A-type analysis of the effect of the reportable event on the registrant and its business), a review of a draft Form 8-K by the registrant's outside counsel (and in some cases, the registrant's public accountants), and a review by the registrant's board of directors and/or audit committee. This stage can be potentially time consuming for a variety of reasons.

For example, Proposed Item 1.02 requires that management analyze and disclose the effects on the company of the termination of a material contract.[128] Legal scholars and practitioners have expressed serious doubts about the feasibility of such an analysis given the short timeframe: "[t]wo business days is not sufficient to draft, review and file a meaningful and well thought out 'mini-MD&A.'"[129]

Even if company officials are able to make the materiality determination within two business days, it will be difficult for them to analyze thoroughly the effects of a particular agreement or event on the company, prepare disclosure statements to summarize that analysis, and review the disclosure internally all within two business days. In some cases, a company may be able to begin its analysis in advance, but in many cases a company may not have all the facts until the date of the event that triggers the disclosure obligation.

In light of the breadth of the proposed Form 8-K disclosure items and the brevity of the prescribed timeframe, there is great danger that the analysis of the information will become more boilerplate. The SEC has recognized the

[127] Comment Letter of Grundfest, *supra* note 116.

[128] *See supra* note 3 and Part III.B.3.

[129] Comment Letter of Grundfest, *supra* note 116.

tendency of registrants to produce boilerplate-type responses to required disclosure items and has warned that such responses will not be acceptable.[130] Preparation of adequate disclosure necessarily entails that the registrants take the time to carefully analyze and prepare the required disclosures. Despite the SEC's warnings otherwise, it is likely that many registrants that are forced to meet a two-business-day filing deadline will resort to standardized boilerplate disclosures in order to avoid the consequences of a late filing.

There is the further risk of issuers inadvertently producing misleading disclosure statements. Many of the new disclosure items[131] require Form 8-K reports to include a MD&A of the agreement or event being reported. If the proposals are adopted as proposed, registrants will have no more than a couple of days to craft a meaningful, thoughtful, and in-depth analysis. For example, describing the potential consequences of a reduction in a customer business relationship can be difficult, and is perhaps best done in the context of a trend disclosure, which undoubtedly takes significant time to prepare. Moreover, a termination or reduction of a customer relationship might be replaced by another, which may not be sufficiently finalized or detectable to announce within the given time period. As the American Bar Association ("ABA") noted, such disclosure could produce

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[130] *See, e.g.*, Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 33,8056, 2002 SEC LEXIS 148 (Jan. 22, 2002) (cautioning that MD&A "should be sufficiently detailed and tailored to the company's individual circumstances, rather than 'boilerplate.'"); Plain English Disclosure, Securities Act Release No. 33,7380, 1997 SEC LEXIS 88 (Jan. 14, 1997) (noting that prospectuses often contain "dense writing, legal boilerplate, and repetitive descriptions of the company's business," and prohibiting such boilerplate disclosures); Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers, Securities Act Release No. 33,7558, 1998 SEC LEXIS 1601 (July 29, 1998) (warning companies to avoid generalities and boilerplate disclosure).

[131] *See* Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3.

severe economic harm to the company, its investors, and the economy: "[d]isclosure of the customer loss, standing in isolation, might cause significant loss in market capitalization, create volatility in the market for the company's securities, trigger defaults and funding freezes under agreements having material adverse change clauses, alarm suppliers, etc."[132]

D. Stage 4: Final Review and EDGARization

The fourth and final stage in the Form 8-K preparation process involves the final review and the EDGARization[133] of the Form 8-K. This stage involves EDGARization of the Form 8-K (including exhibits, which could be hundreds of pages in length in the case of material agreements) by a financial printer and review of the final, EDGARized Form 8-K, including exhibits, to ensure that the EDGARization process was successfully completed. With respect to Form 10-Q and Form 10-K, there is an added requirement of CEO/CFO review and certification.[134] Similar to the three prior stages, this stage can be potentially time-consuming because of the need to ensure accuracy and completeness.

Many have noted that technology permits companies to produce and disseminate information quickly and at

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[132] Comment Letter from Stanley Keller, Chair-Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association, to the SEC (Sept. 12, 2002), *available at* http://www.sec.gov/rules/proposed/s72202/skeller1.htm [hereinafter Comment Letter of ABA].

[133] "EDGAR" is the Electronic Data Gathering, Analysis, and Retrieval system developed in the 1980s and first mandated by the SEC in 1993. It performs automated collection, validation, indexing, acceptance, and forwarding of submissions by companies required to file forms with the SEC. *See* Use of Electronic Media for Delivery Purposes, Securities Act Release No. 33,7234, 17 C.F.R. §§ 230, 232, 239, 240, 270 (October 6, 1995); SEC, IMPORTANT INFORMATION ABOUT EDGAR, *available at* http://www.sec.gov/edgar/aboutedgar.htm; Joseph A. Grundfest, *The Future of United States Securities Regulation: An Essay on Regulation in an Age of Technological Uncertainty*, 75 ST. JOHN'S L. REV. 83 (2001).

[134] *See* Rule on CEO/CFO Certification, *supra* note 84.

increasingly lower costs.[135] As Professor Donald Langevoort explains, "[t]he obvious consequence of this technological evolution is an explosion in the quantity of available information and investment opportunities and a shift in the ability to exploit legitimate informational advantages."[136] The SEC has also cited advances in computers and related technology to justify its accelerated disclosure regime.[137] However, while such technological advances may reduce the time required for disclosure, they do not ensure quality control. Indeed, this stage again underscores the delicate tradeoff between quality and timeliness. On the one hand, rushing through the final review of the report and the exhibits for filings via the EDGAR system could inadvertently lead to inaccurate, misleading, or incomplete disclosures, especially as many of the agreements and other documents the SEC would require take significant time to prepare.[138] On the other hand, conducting the required careful and thoughtful review of the report and the exhibits could risk delayed disclosure.

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[135] *See, e.g.*, Paul G. Mahoney, *Technology, Property Rights in Information, and Securities Regulation*, 75 WASH. U. L.Q. 815, 817 (1997) (noting that "[a]dvances in communications technology continuously reduce the costs of storing, retrieving, transmitting and otherwise manipulating a given amount of data"); Grundfest, *supra* note 133, at 88-93; *see, e.g.*, Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3, at Part 4(b). For a general discussion of the impact of technological advances on the securities markets, see SEC, REPORT TO THE CONGRESS: THE IMPACT OF RECENT TECHNOLOGICAL ADVANCES ON THE SECURITIES MARKETS (Nov. 26, 1997), *at* http://www.sec.gov/news/studies/techrp97.htm (last visited Apr. 14, 2003); Langevoort, *supra* note 11; Wallman, *supra* note 11; McDonough, *supra* note 11.

[136] Langevoort, *supra* note 11, at 757.

[137] *See supra* note 11 and accompany text.

[138] The problems associated with this stage are exacerbated in the case of agreements or other required exhibits that do not already exist in electronic form, or for which an electronic copy cannot be readily obtained. In such cases, the process of obtaining a copy of the agreement, keying in the text, converting it to EDGAR format and proofreading prior to filing could easily take longer than the proposed timeframe of two business days.

E. Foreign Issuers, U.S. Issuers with Foreign Operations, and Small Business Issuers

As illustrated above, the requirements for prompt and simultaneous disclosure are onerous even for the best-equipped companies. However, the problems are especially acute for lesser-equipped companies. In particular, foreign issuers and companies with worldwide operations may experience great difficulties in making the required prompt disclosure. Time zone differences and non-US holidays alone could make it very difficult to meet the two-day filing requirement for an event occurring outside the US or having world-wide impact. In addition, a two-day deadline means West Coast filers must file within one-and-a-half business days, by early to mid-afternoon on the second business day.[139]

Perhaps more troubling is the situation for small businesses.[140] Small entities typically lack extensive finance, accounting and legal staffs, may be given lower priority by their outside auditors, and often rely on outside counsel to handle disclosure responsibilities that larger companies would handle in-house. Indeed, companies with lower revenues and fewer employees generally have lower market capitalizations, meaning that more timely information about smaller companies will generate fewer aggregate benefits for investors. Thus, the expanded Form 8-K disclosures increase costs for the companies for which the disclosures will generate the fewest aggregate benefits.[141]

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[139] *See* Comment Letter of Intel, *supra* note 123.

[140] Item 10 of Regulation S-B defines a small business issuer as a company that has revenues of less than $25 million, is a U.S. or Canadian issuer, is not an investment company, and has less than $25 million of its stock held by the common public. 17 C.F.R. § 228.10 (2003). Also, if it is a majority owned subsidiary, the parent corporation also must be a small business issuer. *Id.* Exchange Act Rule 0-10(a) defines an issuer, other than an investment company, to be a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year. 17 C.F.R. § 240.0-10(a) (2003).

[141] *See* Comment Letter of Grundfest, *supra* note 116.

In the past, the SEC has exempted small entities from several of its core regulations.[142] Yet, it has purposefully chosen not to provide such exemptions to its rules amending Form 8-K. The SEC justifies the lack of exemptions by the need to ensure prompt disclosure. As the SEC contends, "different compliance or reporting requirements or timetables for small entities would interfere with achieving the primary goal of making information about significant corporate events promptly available to investors and the public securities market."[143]

V. REVIEW OF SEC EFFORTS TO OFFSET TRADEOFF

To its credit, the SEC has recognized the tradeoff between quality and timeliness,[144] and has made some efforts to offset it. Among the most important of these efforts are the adoption of a phased-in approach, the establishment of certain extensions to the original deadlines, the creation of a safe harbor, and the elimination of duplicative reporting requirements. While these attempts are laudable, they fall short of providing an effective, long-lasting solution.

A. Phased-In Approach

One way in which the SEC has tried to resolve the quality-timeliness tradeoff is by adopting a phased-in approach of accelerated deadlines. The adopted timeline for the periodic reports contemplates no change in deadlines for the first year (fiscal year ending 2003) and a less extensive

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[142] *See, e.g.*, Rule on Acceleration of Periodic Reports, *supra* note 4; Rule on MD&A about Off-Balance Sheet Arrangements, *supra* note 89; Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms, Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 34,47262, 2003 SEC LEXIS 224 (Jan. 27, 2003) (codified at 17 C.F.R. pts. 240, 249, 270, 274) (allowing a lengthier transition period for small businesses).

[143] Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3.

[144] *See supra* note 12.

ultimate acceleration of the deadline for quarterly reports. The SEC has relied on this approach to ease the transition, stating that:

> A phased-in approach of accelerated deadlines allows a greater transition period for companies to adjust their procedures and to develop efficiencies to ensure that the quality and accuracy of reported information will not be sacrificed. Under a phased-in approach, companies will have additional time to plan for and adjust their reporting schedules and processes to ensure that the necessary reviews will not be sacrificed. . . . At the same time, a phased-in approach allows investors to begin to experience the benefits of an accelerated flow of information. A phased-in approach also will provide the Commission with an opportunity to understand how each incremental change affects the disclosure process.[145]

Indeed, the phased-in approach may help to alleviate the immediate impact of any costs and burdens on issuers. Nevertheless, it does little to address the long-term consequences. The new Form 8-K disclosure requirements mandate companies to change in significant ways how they monitor, analyze, prepare and file disclosures regarding certain potentially "material" events. These procedures will be costly to issuers. As noted above, small business issuers and foreign issuers may have a difficult time reaching these deadlines, even given the adjustment period. As the SEC itself admits, "[e]ven with a phase-in period, accelerating filing deadlines may create the risk that more companies will file their reports late or need a filing extension."[146]

B. Rule 12b-25 Extensions

Another method adopted by the SEC to attempt to resolve the tensions is allowing for certain filing extensions. Rule 12b-25[147] of the Exchange Act extends by up to five days the

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[145] Rule on Acceleration of Periodic Reports, *supra* note 4.

[146] *Id.*

[147] Exchange Act Rule 12b-25, 17 C.F.R. § 240.12b-25 (2003).

filing deadline of quarterly reports on Form 10-Q and by up to fifteen days for annual reports on Form 10-K. To qualify for these extensions, the issuer must file a Form 12b-25[148] no later than one business day after the due date for such report.

The SEC is currently considering amendments to Rule 12b-25 to allow for a two-day extension on the filing of Form 8-K. Thus, tagging on the two-day extension to the original two-day deadline, the issuer would have a total of four days to file Form 8-K without penalty of losing short form eligibility and other eligibilities.

However, a key defect of Rule 12b-25 is that notification of a late filing under Form 12b-25 notice may alarm the market by signaling that the company plans to disclose potentially material information. This would naturally lead to speculation about whether the news is positive or negative, and would be an unnecessary and expensive increase in volatility in the trading of the company's securities. In addition, the complexity of the Rule 12b-25 procedures[149] may divert issuer attention from the more important task of preparing and filing the Form 8-K report itself.[150]

C. Safe Harbor

A third attempted solution to reduce the regulation's burden on issuers, underwriters, and their legal counsel is the creation of a safe harbor. Specifically, the proposed rules create a new safe harbor from liability under sections 13(a) and 15(d) of the Exchange Act,[151] provided that the following two conditions are met:

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[148] Form 12b-25, 17 C.F.R. § 249.322 (2003), *available at* http://www.sec.gov/divisions/corpfin/forms/12b-25.htm (last visited Apr. 14, 2003).

[149] Part III of Form 12b-25, for example, requires companies to state "in reasonable detail" the reasons why the particular report could not be filed within the relevant prescribed deadline. *Id.*

[150] *See* Comments of Cleary Gottlieb, *supra* note 111.

[151] Exchange Act, *supra* note 25.

- On the Form 8-K due date, the company maintained sufficient procedures to provide reasonable assurances that it was able to collect, process and disclose, within the specified time period, the information required to be disclosed by Form 8-K; and
- No officer, employee or agent of the company knew, or was reckless in not knowing, that a report on Form 8-K was required to be filed, and once an executive officer of the company became aware of the failure to file, the company promptly (and not later than two business days after becoming aware of the failure) filed a Form 8-K with the required information and stating the date, or approximate date, on which the report should have been filed.[152]

The stated purpose of the safe harbor provisions is "to accommodate companies that do not file a report in a timely manner despite making a good faith effort to file such reports." However, these safe harbor provisions may not be completely effective, especially due to the ambiguity of the conditions. Such terms as "sufficient procedures" and "reasonable assurances" are not specifically defined in the rules, leaving companies with little guidance to assess whether they have satisfied the safe harbor requirements.

Moreover, many commentators have argued that the safe harbor does not go far enough.[153] Specifically, the safe harbor does not provide protection from violations of other securities laws, including Rule 10b-5 of the Exchange Act and sections 11, 12 and 17 of the Securities Act. Despite the safe harbor, a company that fails to make a timely 8-K filing is also ineligible to use short-form registration statements for one year (unless it makes a timely 12b-25 filing and files the Form 8-K within two days of the 12b-25 filing) and its shareholders would not be able to rely on Rule 144 of the Securities Act.

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[152] Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3.

[153] *See, e.g.*, Comments of Cleary Gottlieb, *supra* note 111; Comment Letter of Grundfest, *supra* note 116.

D. Elimination of Duplicative Reporting Requirements

The SEC has also attempted to address the tradeoff by eliminating any duplicative reporting requirements in annual and quarterly reports. Additionally, under the Form 8-K proposals, the SEC has said that the filing under Rules 165, 14d-2(b) and 14a-12 can incorporate the merger agreement by reference to the Form 8-K. The SEC has also downplayed the reporting costs by estimating that the proposed Form 8-K revisions would only result in two more filings per issuer per year.[154] As the SEC explains in its proposal, "[b]ecause reporting companies already file Form 8-K for some events, no additional professional skills beyond those currently possessed by these filers would be necessary to prepare the form for the proposed new types of events."[155]

However, commentators have pointed out that the estimated two-filing-per-year increase is an understatement, especially for smaller companies. As one group of law professors and practitioners explained in their comment letter to the SEC:

> The significant expansion in the type and number of Form 8-K triggering events will significantly increase the volume of Form 8-K filings. This increase in the number of filings could lead investors to view these filings as more routine, thereby creating a risk that truly material information will escape notice. We believe that the SEC's estimate that the proposed Form 8-K revisions would only result in two more filings per company per year is far too low, especially for smaller companies, which, given their size, are parties to a greater number of transactions and business relationships that are considered material.[156]

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[154] *See* Proposed Rule on Additional Form 8-K Disclosure, *supra* note 3.

[155] *Id.*

[156] Comment Letter of Grundfest, *supra* note 116.

VI. RECOMMENDATIONS

In view of the arguments and issues raised above, it follows that there is a serious need for policy and legal reforms to the current issuer reporting requirements. This section suggests useful and realistic ways to achieve the objectives of regulators concerned about quality and timeliness while avoiding most of the compromises, at the same time taking into account the salient tradeoffs between the two objectives.

A. Segregating Disclosure Items

Perhaps the simplest and most effective solution to address the quality-timeliness tradeoff is to assign different filing deadlines to different disclosure items, segregating the items giving rise to a disclosure obligation according to their significance and complexity. The concept behind such a segregated scheme is that, while some of the items are both highly significant and easier to detect and analyze than others (justifying a shorter filing deadline), other proposed items involving events are more burdensome to detect and/or have less significance to investors (justifying a longer filing deadline).[157]

According to one proposal,[158] the items required to be disclosed under Form 8-K should be segregated into two categories, with the first category having a filing deadline of five business days and the second category having a filing deadline of fifteen business days. Under the proposed scheme, the first category should include only "those items that would, by their nature, pose less difficulty to registrants in preparing accurate and complete disclosure of such items in the five-business-day period. Items in this category should be relatively objective and not require difficult

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[157] *See supra* Part IV.B for discussion of the different types of information.

[158] Comment Letter from Sullivan & Cromwell to the SEC (Aug. 26, 2002), *available at* http://www.sec.gov/rules/proposed/s72202/sullivan1.htm.

materiality judgments. Examples of items in this first category include bankruptcy/receivership, departure of directors or principal officers be included in the first category, and amendments to articles of incorporation or bylaws. By contrast, the items in the second category would include items that are "more likely to require judgments as to materiality and significant efforts by management to prepare accurate and complete disclosure in keeping with the [SEC]'s desire that such disclosure not be boilerplate and include meaningful analysis."[159] According to the proposal, examples of second-category items include entry into a material agreement, termination or reduction of business relationship with customer, and creation of a direct or contingent financial obligation that is material to the issuer.[160]

Other concrete examples of such a segregated scheme of reporting can be found in several of the comment letters submitted to the SEC.[161] Although each of the proposed segregation schemes differ in the specific categorization and deadlines, all are permutations of a single theme: to find an appropriate balance between investors' need for timely information and the time needed by companies to prepare accurate, complete and meaningful disclosures.

B. Filing by Amendment

A second proposal aimed at striking a more appropriate balance between the dual objectives is to permit issuers to file by amendment. That is, companies should be allowed to amend their filings after the due date, to ensure that adequate time is allowed for the preparation of the supplementary documents and exhibits. As one comment letter suggested,[162] the SEC should adopt a rule that requires companies to report the events called for by the various

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[159] *Id.*

[160] *Id.*

[161] *See, e.g.*, Comment Letter of Intel, *supra* note 123; Comment Letter of Grundfest, *supra* note 116.

[162] *See* Comments of Cleary Gottlieb, *supra* note 111.

disclosure items within two business days, but permit analytical information and exhibits to be filed by amendment within a given additional period (e.g., three business days) after the two-business-day deadline. This bifurcated approach would alleviate the difficulties companies have in obtaining, preparing, translating, and proofreading the exhibits, or preparing confidential treatment requests, "ensur[ing] prompt reporting of the event itself, while allowing companies sufficient time to prepare more thoughtful and useful disclosure for investors."[163]

C. Adopting Bright Line Standards and Clarifying the Definitions of Vague Events and Items

In order to alleviate the ambiguities inherent in materiality judgments,[164] the SEC could consider adopting bright line standards with well-defined and objective triggering events. For example, the SEC could clarify the definition of an "agreement," so that it is clear whether the term "agreement" encompasses, for example, such items as non-binding agreements and letters of intent. Guidance as to the meaning of "ordinary course of business" would also be helpful to issuers.

Adopting bright line rules, in which each proposed item has a well defined and objective disclosure triggering event, would simplify the task of identifying which contracts or obligations must be disclosed, saving time and making it easier for companies to meet the specified deadline. As the ABA has stated, "[t]he greater the objectivity of the triggers, obviousness of materiality and likelihood of the information being promptly known to senior management, the more feasible are relatively short event-driven reporting deadlines."[165] Legal scholars, such as Steinberg and Goldman, have also highlighted the need for a bright-line test, suggesting that it provides a degree of certainty in an area that has enormous liability risks:

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[163] *Id.*

[164] *See* discussion of materiality, *supra* Part IV.A and note 67.

[165] Comment Letter of ABA, *supra* note 132.

> Without such a [bright line] standard, one is left with the uncertainty of trying to determine at what point negotiations become material. Thus, an uncertain materiality test creates difficult counseling situations and liability concerns, particularly given that any adjudication will be determined with the benefit of hindsight . . . It is inequitable to subject issuers to both the burden of disclosure and the risk of liability by mandating disclosure in the absence of definitive guidelines as to when disclosure is required . . . [The SEC should provide] a pragmatic yardstick for measuring ripeness.[166]

D. "Testing the Waters" Approach

Another approach is for the SEC to regulate in incremental steps. This consists of first "testing the waters" by implementing less demanding regulations and then, only if those prove successful, implementing progressively more demanding ones. As one commentator proposes:

> The SEC could mandate that companies start publicizing on their websites real-time revenue figures. Beginning with small efforts would enable companies to determine whether there is actually a demand for this type of data. It would also be an opportunity to see whether companies experience undue hardship by having to generate real-time figures . . . . Only after the above scenario proves effective would any of the other solutions make sense. It is much easier to take small steps to reach a goal than make one large step and lose your footing along the way. If demand for this real-time figure was high and companies seemed to respond favorably, then the next step could . . . entail an SEC mandate to companies to continuously update

[166] Steinberg & Goldman, *supra* note 30, at 928-29, 952.

> [MD&A]. Over time, SEC could phase out periodic reporting.[167]

This approach is based partially on the same reasoning as the phased-in approach the SEC adopted in relation to the acceleration of the annual and quarterly reporting deadlines, namely, that it is better to move gradually than dramatically in one fell swoop. However, a key advantage of this approach over the phased-in approach is that it is fairly adjustable. That is, under the "testing-the-waters" approach, should the initial steps fail and/or prove unwise, regulators would be prompted to adjust future reforms according to the weaknesses of the prior ones. In contrast, under the phased-in approach, the rules have been passed and companies have anticipated the regulatory changes, so as to make adjustments much more difficult.

While this approach offers great benefits, it should be noted that its implementation might pose certain difficulties. One difficulty relates to the political process. The SEC does not operate in a political vacuum, and efforts to issue a new rule may generate political backlash. To the extent that such political difficulties hinder the rulemaking process, the "testing-the-waters" approach of moving in incremental steps may prove impractical.

Another possible hindrance to the effectiveness of this approach is that rulemaking entails significant administrative costs. In general, whenever the SEC proposes to issue, amend, or repeal any rule or regulation, it must submit a notice of the proposed action in the *Federal Register* and allow interested persons the opportunity to comment on the matter.[168] In addition to this notice and comment requirement, the SEC must engage in a cost-benefit analysis. The SEC also must consider the impact on

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[167] Prohs, *supra* note 119, at 496. *See also id.* at 497 (arguing that "[i]t is . . . not necessary that the SEC promulgate earth-shattering rules" and that "[i]n order for a real-time reporting system to be successful, it will be necessary to take small steps").

[168] Rule 192, SEC Rules of Practice, 17 C.F.R. pt. 201.192 (2003), *available at* http://www.sec.gov/about/rulesofpractice.shtml.

efficiency, competition, and capital formation.[169] In addition, the Regulatory Flexibility Act directs the SEC to consider significant alternatives that would accomplish similar objectives as that of the proposal, while minimizing any significant adverse impact on small entities.[170] And for purposes of the Paperwork Reduction Act,[171] the SEC must estimate the additional burden hours and external costs on the affected reporting companies expected from the reform.

VIII. CONCLUSION

Laws mandating improved quality and faster disclosure of corporate information are becoming a common feature of the regulatory landscape of securities law. Indeed, the ambitious mandates of the Sarbanes-Oxley Act's real-time disclosure provisions and the SEC acceleration and expansion of disclosures in periodic reports indicate how rigorously and broadly these dual objectives are being advanced. Proposals awaiting promulgation, such as the extensive amendments to Form 8-K, are a sign that such initiatives will likely continue.

To be sure, the individual objectives of improved quality and timeliness are important to ensure investor protection, investment, and efficiency, and should continue to be emphasized in future reforms to the disclosure regime. However, as the above analysis suggests, efforts by regulators to push for both goals concurrently may lead to compromises in either or even both. It is necessary to

[169] Specifically, Section 23(a)(2) of the Exchange Act requires the SEC, when adopting rules under the Exchange Act, to consider the anti-competitive effects of any rule it adopts. 15 U.S.C. 78w(a)(2) (2000). In addition, Section 2(b) of the Securities Act of 1933 [15 U.S.C. 77b(b)], Section 3(f) of the Exchange Act [15 U.S.C. 78c(f)], and Section 2(c) of the Investment Company Act [15 U.S.C. 80a-2(c)] require the SEC, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.

[170] *See* Initial Regulatory Flexibility Analysis, 5 U.S.C. § 603 (2000).

[171] 44 U.S.C. § 3501 (2000).

recognize that these objectives are—to a much greater extent than often realized by the relevant standard setters—competing. Simply put, there is often an unavoidable tradeoff between the speed with which a disclosure is delivered and the accuracy, analytical depth, and thoughtfulness of the disclosure.

Future reforms should accommodate the reality that advancing both objectives concurrently, without a proper balance between them, may be counterproductive toward reaching the underlying ends of securities regulation. The advantages realized from mandating prompt disclosure would be meaningless if the information disclosed was not accurate or complete. Similarly, the benefits of high quality information would be severely undermined if releases of such information were somehow delayed.

This section of the Survey offers no magic solution, and it is silent on the "right" balance between the two objectives. Its focus is mainly on identifying the tradeoffs and tensions associated with pursuing the objectives simultaneously, rather than on weighing the relative importance of each objective. Nonetheless, the implications of this analysis do suggest that it is worthwhile to reexamine these objectives and to think carefully about their importance in today's ever-changing securities markets. Indeed, what shape the "right" balance takes should be primarily a function of the importance that the investment world places on each of the respective goals. Should the objectives, when weighed against each other, and considered in light of the interests of the investment world, be deemed equally important, regulators should design a disclosure regime to strike an even balance. However, should consensus exist that the benefits of one objective outweigh those of the other, reforms should accordingly stress the objective perceived as more beneficial. Finding the "right" balance will be thorny, but it represents a worthwhile challenge to be taken up in the coming years.