

## NITS, GRITS, AND SOFT INFORMATION IN SEC FILINGS

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The corporate image created by a prospectus, proxy statement, or other Securities and Exchange Commission (SEC) filing may be likened to a shadow—it tells something about the subject's gross outline but in a flat, lifeless, and sometimes distorted form. Many commentators, including SEC Chairman William J. Casey,<sup>1</sup> have suggested that SEC disclosure filings should be more lifelike representations, devoting greater attention to economic realities and the nitty-gritty of the business, and including certain types of forward-looking information, rather than boilerplate phrases and standard disclaimers which could fit almost any filing.

Historically, certain types of information, highly relevant to investment decisions—referred to herein as “soft” information—have been largely excluded from SEC filings, primarily because of the Commission's policy. Recently, however, the SEC, analysts and other market professionals, the courts, and investors have shown interest in the expanded use of such information in these documents. Consequently its greater use seems to be inevitable.

This Article will consider several categories of soft information traditionally excluded from filings and will examine some of the policy implications of this practice. Since its basic theme is to suggest a shift in attitude to allow, and possibly even require, more soft information in SEC filings, the policies that should control the use of such information will also be explored.

### I. IDENTIFICATION OF SOFT INFORMATION

The content of SEC filings has traditionally been confined to what may be called “hard” information, meaning statements concerning objectively verifiable historical events or situations—commonly

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An abbreviated version of this Article was presented as an address to the 1972 Annual Meeting of the American Bar Association in San Francisco on August 15, 1972. A transcript will appear in the January, 1973, issue of *Business Lawyer*.

<sup>1</sup> See, e.g., Addresses by SEC Chairman Casey: New York Financial Writers Association, June 7, 1971, in 105 BNA SEC. REG. & L. REP. F-1 (June 9, 1971); American Bankers Association, Mar. 17, 1972, reported in 144 BNA SEC. REG. & L. REP. A-7 (Mar. 22, 1972); Conference on Financial Reporting, May 19, 1972, reported in 153 BNA SEC. REG. & L. REP. A-5 (May 24, 1972).

called "facts"<sup>2</sup> in SEC parlance—as distinguished from opinions, predictions, or subjective evaluations. Although a comprehensive definition of soft information is not readily apparent, several non-exclusive and non-exhaustive categories can be identified: (1) forward-looking statements concerning the future, such as projections, forecasts, predictions, and statements concerning plans and expectations; (2) statements concerning past or present situations when the maker of the statement lacks the data necessary to prove its accuracy—for example, information on a company's historical share of the market, when it does not have access to precise statistics concerning its competitors; (3) information based primarily on subjective evaluations—for example, representations concerning the competence or integrity of management, the relative efficiency of a manufacturing operation, or the appraised value of assets; (4) statements of motive, purpose, or intention, since it is frequently easier to verify objectively what was done than to determine why it was done—for example, explanation of the reasons for which an auditor has been discharged;<sup>3</sup> (5) statements involving qualifying words, such as "excellent," "ingenious," "efficient" and "imaginative," for which there are no generally accepted objective standards of measurement in most contexts.<sup>4</sup>

<sup>2</sup>The SEC has given particular stress to the difference between "fact" and other types of information in setting forth guidelines for public disclosure of an issuer "in registration." See SEC Securities Act Release Nos. 5180 (Aug. 16, 1971), 5009 (Oct. 7, 1969), 3844 (Oct. 8, 1957); SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 95-96 (1969) [hereinafter cited as WHEAT REPORT].

<sup>3</sup>See Schneider, *Developments in 1934 Act Reporting*, PLI 3D INST. ON SEC. REG. 110-11 (1972). In certain instances, motive must be disclosed. *Cochran v. Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y. 1962) (anti-fraud rules could be violated by failure to disclose motive for cut in company's dividend rate). But see *Lester v. Preco Indus., Inc.*, 282 F. Supp. 459 (S.D.N.Y. 1965) (allegation that at time of registration officers intended to mismanage corporate funds not sufficient to bring action under anti-fraud rules).

For an example of an attempt to examine motive, see *Wall St. J.*, Nov. 24, 1972, at 4, col. 3: "Asked to explain the resignation [of Lybrand, Ross Bros. & Montgomery as auditors for International Controls Corp.], an officer replied 'There isn't any one specific reason. In general, it related to our feeling that the auditor-client relationship we desire to maintain can't be so any longer.' Pressed for specifics, [he] declined to list them . . ."

Compensating balance arrangements also fall within this category of soft information. "Lack of disclosure [of compensating balance arrangements] has been justified on the grounds that such arrangements were generally unwritten, informal and not subject to precise quantification. None of these reasons are sufficient to support a policy of nondisclosure of a phenomenon which is recognized to be real and significant." Draft guidelines circulated by the SEC, discussed at 180 BNA SEC. REG. & L. REP. A-10 (Dec. 6, 1972), and reprinted in *id.* J-1.

<sup>4</sup>In preparing a prospectus for a manufacturer of office copying machines, management blithely described the copies produced as "permanent" in discussing the product with the underwriters. This was in an era when many such devices made copies which faded on exposure to sunlight. But what does the word "permanent" mean in relation to a piece of paper, when even Dead Sea scrolls turn brittle around the edges after a few thousand years? Although the businessmen seemed to know what a "permanent" copy was, the lawyers were not certain. The prospectus adopted the circumlocution that the copies would resist deterioration and fading as well as any normal printed matter,

"Hard" and "soft" must be recognized as highly relative concepts suggesting no sharp dividing line. Many apparently hard statements have soft cores and vice versa. Audited historical financial statements are normally considered to be a classic type of hard information. Accounting is not an exact science, however, and many subjective evaluations and other types of soft information must be considered in order to prepare audited financials.<sup>5</sup> On the other hand, many types of soft information contain an element of "fact." Thus, statements about a man's excellent reputation for integrity and creativity are normally considered to be too soft for inclusion in a prospectus, although existence of a reputation has been considered a "fact" which can be proven in court under traditional rules of evidence.<sup>6</sup> Similarly, the existence of a plan for the future may be treated for various purposes as a "fact," even though the plan may be very indefinite and subject to many contingencies which often cannot be controlled.

The dividing line between hard and soft information is sometimes bridged by casting statements in terms of beliefs, opinions, or expectations.<sup>7</sup> Thus, the statement that a company believes itself to be the

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whatever that may mean. See Prospectus, Magnefax Corp., SEC Reg. File No. 2-17,943 (May 31, 1961).

<sup>5</sup> Soft information in financials relates to such matters as: the establishment of reserves for bad debts, litigation, and tax audits; judgments concerning the degree of profitability and extent of completion of open contracts when using percentage of completion accounting; judgments concerning useful lives of assets (based on factors of wear and also obsolescence) in calculating depreciation; and valuing intangible assets, such as patents or good will of an acquired business. Litton Industries has been questioned for preparing earning statements improperly based upon estimates of a recovery on a \$450 million claim against the government. See 162 BNA SEC. REG. & L. REP. A-10 (July 26, 1972). Chairman Casey has recently commented on this area:

*It seems vital to me that [accountants] correct the impression that accounting is something which produces exact measurements—that it is a scale on which a business can be weighed to get an exact and precise answer as to its performance and the degree of its progress in any particular period and its value. It seems to me that there is a need for greater public understanding that the accounting process relies on and produces estimates.*

Accountants have encouraged the public to think of accounting as an exact science by producing a single number result and limiting accountants' responsibility to a single, segregated section of reports to shareholders, *when the essence of the accrual system of accounting is estimation and prediction of future events.*

Address by SEC Chairman Casey, American Institute of Certified Public Accountants, Oct. 2, 1972, at 6-7 (emphasis added).

<sup>6</sup> C. McCORMICK, EVIDENCE § 44 (2d ed. W. Cleary 1972). Traditional rules of evidence sometimes distinguished between reputation and character. A man's character is said to be too subjective or elusive an attribute to be a proper subject of evidence, although his reputation is an objective, provable fact.

Reputation, of course, differs somewhat from an opinion held by a particular individual. *Id.* Thus, a particular individual may hold another person in low regard, although the holder of the opinion may recognize that the subject of the opinion has an excellent reputation.

<sup>7</sup> Chairman Casey made a similar point in a recent speech regarding the Commission's reconsideration of its policy on forecasts:

Then, there is the question of whether we can really justify the prohibition of forecasts which are carefully prepared, relied on for budgeting and planning purposes, based on comprehensive data and reasonable assumptions and well articulated and regularly supplemented to reflect supervening developments and

largest producer of a product purports to be a statement of a “fact”—that is, the fact about the belief held—even though the subject of the belief may be soft information, if the company does not have precise information about its competitors.

The Commission has been particularly ingenious in turning soft representations into hard ones (one might call them pseudo-hard) by using the “implied representation” technique. This approach is employed extensively by the SEC in broker-dealer administrative proceedings, typically when a salesman has made a very optimistic forecast expressed in terms of his opinion or belief. The Commission holds that every expression of opinion contains an implied representation of “fact”—namely, the fact that the opinion has an adequate basis. If the Commission discerns no adequate basis for the opinion, it finds a misrepresentation in this implied factual representation.<sup>8</sup>

The dividing line may be especially blurred when dealing with the future, depending on whether the statement is an affirmative representation about what will occur or a statement about a present plan or expectation for the future. The relative hardness of a statement should turn less on its form (for example, a statement concerning what will happen as opposed to a statement of present expectation) and more on the underlying substance. If a company has a firm agreement to buy a property, with closing scheduled ten days after the effective date of its prospectus, and all closing preconditions have been satisfied, a statement that the company “will” (or presently proposes to) purchase the property may be considered reasonably hard, and, therefore, acceptable for prospectus inclusion under current practice. But a statement that the company will (or even the softer statement that it presently expects or proposes to) open one hundred additional branches over the next five years, when no further locations have been selected, would be too soft for inclusion in a prospectus under prevailing standards.

## II. PREVAILING PRACTICES OF EXCLUSIONS

There has been something of a “conspiracy of silence” in excluding soft information from SEC filings. The Commission and private parties preparing SEC filings, each for their own reasons, have generally (with

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revisions in estimates. If we do prohibit forecasts which a company makes and circulates, are we subjecting the company to statutory liability for failure to disclose a material fact? *The forecast is an estimate but its existence and the articulated judgment it represents is a fact.*

Address by SEC Chairman Casey, Financial Executives Institute, Oct. 18, 1972, at 16-17 (emphasis added).

<sup>8</sup> Cohen & Rabin, *Broker-Dealer Selling Practice Standards*, 29 LAW & CONTEMP. PROB. 691, 704-05 (1964). The Commission has gone so far as to establish conclusively that certain types of opinions may never be adequately based in fact, such as opinions that there will be a very sharp rise in the market price of a speculative security.

some exceptions) excluded soft information from such filings. Although the prevailing attitude on soft information has emerged primarily in contexts concerning registration statements filed under the 1933 Act,<sup>9</sup> the same approach is normally applied (with some exceptions) on a fairly uniform basis to other types of filings—proxy statements and periodic reports for example.

#### A. *The Traditional SEC Position*

The Commission has been motivated by a desire to protect investors against questionable selling literature, as well as to aid in the enforcement of statutory liabilities.<sup>10</sup> SEC filings, especially 1933 Act prospectuses, traditionally have been considered to be among the most accurate and reliable (although not necessarily the most useful) sources of information available to investors. The Commission tries to confine these documents to hard information to assure a continued high degree of reliability. Moreover, since it is generally more difficult to prove an inaccuracy in soft information, the limitation of filings to hard information makes it easier to establish accountability for inadequate disclosures.

Furthermore, according to the traditional SEC view, the inclusion of soft information in filings would clothe such information with an unduly high aura of credibility. Investors assume, with a great deal of justification, that information appearing in SEC filings has been prepared with considerable care, tending to assure its accuracy.<sup>11</sup> Therefore, under the SEC's approach, if soft information appeared in a prospectus, the public would incorrectly assume an unwarranted degree of reliability—that a prediction or projection would almost certainly be fulfilled, or that any statement made is subject to verification by objective evidence.

The bootstrap element in this logic is apparent. If the public assumes that filed information is completely verifiable by objective data,

<sup>9</sup> Securities Act of 1933, 15 U.S.C. §§ 77a et seq. (1970) [hereinafter cited as 1933 Act].

<sup>10</sup> For two excellent and rather critical expositions of the traditional SEC position, see Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U.L. REV. 1151 (1970) [hereinafter cited as *Myths*]; Mann, *Prospectuses: Unreadable or Just Unread?—A Proposal to Reexamine Policies Against Permitting Projections*, 40 GEO. WASH. L. REV. 222 (1971) [hereinafter cited as *Prospectuses*]. A more sympathetic analysis of the SEC position appears in Heller, *Disclosure Requirements Under Federal Securities Regulations*, 16 BUS. LAW. 300 (1961). For a judicial exposition of the traditional SEC view, see *Union Pac. R.R. v. Chicago & N.W. Ry.*, 226 F. Supp. 400, 408-09 (N.D. Ill. 1964).

<sup>11</sup> Investors may also assume, with some though by no means total justification, that the SEC itself has verified the statements in a prospectus, notwithstanding the boldface warning on the cover to the contrary. The Staff certainly does make comments or requests for supplemental information designed to verify the accuracy and adequacy of some disclosures, especially those which have elements of softness.

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