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Do the Securities Laws Promote Short-Termism?

James J. Park*

Since 1970, the Securities and Exchange Commission (SEC) has required public companies to file reports summarizing their financial performance on a quarterly basis. Such mandatory quarterly disclosure has recently been criticized as incentivizing corporations to deliver short-term results rather than developing sustainable, long-term strategies. This Article examines the origins of the quarterly reporting system to assess whether the SEC should reduce the frequency of periodic filings. It concludes that much of the pressure on public companies to deliver short-term results emerged as the market increasingly focused on earnings projections issued by research analysts. The pressure to meet such projections can distort the behavior of public companies, but such distortions will only be significant in certain circumstances. Because it is unclear that the quarterly reporting system substantially impacts company incentives, the SEC should pursue modest reforms rather than take the radical step of eliminating quarterly disclosure. Quarterly disclosure is one example of how securities law tends to promote the short-term interests of transacting investors. In contrast, corporate law, which mediates the interests of shareholders, often gives managers the discretion to consider long-term interests. Strong securities law can be balanced by weak corporate law.

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INTRODUCTION

The market value of a public company rises and falls based on its ability to meet the expectations of investors. In a well-established quarterly ritual, companies

release financial statements that will be closely scrutinized by the market.[1] If a company does not meet forecasts of its performance, its stock price can plummet.[2] Corporate managers may be replaced if they do not consistently meet quarterly projections.

Over the last several years, some of the most prominent representatives of Corporate America have argued that the pressure of mandatory quarterly disclosure creates incentives for public corporations to focus on meeting the short-term expectations of the market rather than developing businesses that prosper over the long-term and make positive contributions to society.[3] The criticism of quarterly disclosure gained momentum in the fall of 2018 when President Trump asked the SEC to consider whether it should only require annual or semiannual disclosure to reduce the burden of quarterly scrutiny on public companies.[4] The SEC responded

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1. Section 13 of the Securities Exchange Act of 1934 contains the basic mandate of periodic disclosure. *See* 15 U.S.C. § 78m (2012). Companies subject to Section 13 must file an annual report as well as quarterly reports. *See* SEC, FORM 10-K (2018) [hereinafter FORM 10-K]; SEC, FORM 10-Q (2018) [hereinafter FORM 10-Q].

2. *See, e.g.*, FIN. EXECS. RESEARCH FOUND., FIN. EXECS. INT'L, A SURVEY OF INVESTOR RELATIONS AND EARNINGS GUIDANCE 3 (2015) ("There is often a stock market reward for meeting or beating expectations and a penalty for failing to do so.").

3. Martin Lipton, the prominent corporate lawyer, is a long-time critic of short-termism and proposed eliminating quarterly disclosure in 2015. David Benoit, *Time to End Quarterly Reports, Law Firm Says*, WALL ST. J. (Aug. 19, 2015), https://www.wsj.com/articles/time-to-end-quarterly-reports-law-firm-says-1440025715 [https://perma.cc/6LC6-TT4T]; *see also* Steven A. Rosenblum, *Corporations: The Short-Termism Debate*, 85 MISS. L.J. 697, 709 (2016) ("[E]very publicly traded company is subject to what I think of as the tyranny of quarterly earnings. If you miss your quarterly earnings, you get punished, and that's just a fact of life for every public company, and that's been true before activists."). In 2018, Jamie Dimon, the CEO of J.P. Morgan, and the legendary investor Warren Buffett proposed that companies no longer issue guidance about their earnings. *See* Jamie Dimon & Warren E. Buffett, *Short-Termism Is Harming the Economy: Public Companies Should Reduce or Eliminate the Practice of Estimating Quarterly Earnings*, WALL ST. J. (June 6, 2018), https://www.wsj.com/articles/short-termism-is-harming-the-economy-1528336801 [https://perma.cc/9S3D-SRKK]. Periodically, commentators have observed that the focus of markets on quarterly earnings results in short-termism. *See, e.g.*, MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 134–35 (1995) (describing proposal to eliminate quarterly reports to address market myopia); ROBERT G. ECCLES ET AL., THE VALUEREPORTING REVOLUTION: MOVING BEYOND THE EARNINGS GAME 4 (2001) ("[M]anagers, analysts, and shareholders feel themselves trapped in a short-term earnings game that none of them really likes, but all see no choice but to play."); MICHAEL T. JACOBS, SHORT-TERM AMERICA: THE CAUSES AND CURES OF OUR BUSINESS MYOPIA 32 (1991) ("Business leaders complain that pressures from shareholders to meet short-term performance bogeys are undermining their ability to build competitive enterprises."); LAWRENCE MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT 133 (2001) (proposing elimination of quarterly disclosure); David Millon, *Radical Shareholder Primacy*, 10 U. ST. THOMAS L.J. 1013, 1019 (2013) ("From the perspective of radical shareholder primacy, management would violate its duty as agent of the shareholders if it were to pursue some other objective that had the effect of reducing quarterly earnings, such as the long-run sustainability of the corporation or some kind of social responsibility agenda.").

4. Dave Michaels et al., *Trump Asks SEC to Ease Earnings Reporting*, WALL ST. J., Aug. 18, 2018, at A1. The order came in the form of a Tweet and was prompted by a conversation with the CEO of Pepsi.

to the presidential request by asking for comments on the question of whether the "existing periodic reporting system . . . foster[s] an inefficient outlook among registrants and market participants by focusing on short-term results."[5]

The proposal to eliminate quarterly disclosure connects to a heated debate about whether short-termism, where public companies take "actions that are profitable in the short term but value-decreasing in the long term,"[6] is a significant problem. Over the last several years, legal scholars have generally focused on activist hedge funds as the primary driver of short-termism.[7] Much of the debate has focused on the implications of such activism for corporate law.[8]

Given the efforts over the last few decades to increase disclosure obligations,[9] the proposal to eliminate quarterly disclosure seems problematic and unworthy of much discussion.[10] There is limited evidence that short-termism causes significant problems for publicly traded companies.[11] Even if it did, changing the frequency of

5. Request for Comment on Earnings Releases and Quarterly Reports, Securities Act Release No. 33-10588, Exchange Act Release No. 34-84842 (Dec. 18, 2018).

6. Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1638–39 (2013); *see also* Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554, 1558 (2015) (defining short-termism as "taking steps that boost the short-term stock price but reduce the economic value created by the firm over the long term").

7. *See, e.g.*, Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 8 (2010) ("[M]any activist investors hold their stock for a very short period of time and may have the potential to reap profits based on short-term trading strategies that arbitrage corporate policies."); *see also* Jeff Schwartz, De Facto *Shareholder Primacy*, 79 U. MD. L. REV. (forthcoming 2020) (arguing that hedge funds leverage transparency to pressure companies to maximize shareholder wealth). Before hedge fund activism became somewhat common, the rise of hostile takeovers and pressure from institutional investors were criticized as the primary contributors to short-termism. *See, e.g.*, Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 203 (1991) ("The ascendency of the institutional stockholder and the hostile takeover, however, creates an emphasis on short-term results that makes it increasingly difficult for the corporation to maintain the long-term focus necessary to its own and society's well-being."); *see also* MITCHELL, *supra* note 3, at 3 (arguing that the "root" of short-termism "is the corporate structure itself . . . .").

8. *See, e.g.*, Bebchuk, *supra* note 6 (describing prevalence of the short-termism argument in corporate law); Strine, *supra* note 7 (describing short-termism as a corporate governance problem); *see also* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001) (noting widespread agreement that "corporate law should principally strive to increase long-term shareholder value").

9. *See, e.g.*, Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Securities Act Release No. 33-8128, Securities Exchange Act Release No. 34-46464 (Sept. 5, 2002) ("[W]e believe that periodic reports contain valuable information for investors.").

10. A group of posts on the Columbia Law School *Blue Sky Blog* documented the early reactions of several leading securities law scholars to the Trump proposal. *See August 2018*, CLS BLUE SKY BLOG, https://www.clsbluesky.law.columbia.edu/2018/08/ [https://perma.cc/4J9P-QWVA].

11. *See, e.g.*, Mark J. Roe, *Stock Market Short-Termism's Impact*, 167 U. PA. L. REV. 71, 87 (2018) (presenting evidence that "short-term theory is either unsupported (R&D), contradicted (buybacks as draining cash, stock markets as shunning the future), or better explained otherwise (capital expenditure)"); *see also* Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015) (finding no evidence that hedge fund activism reduces long-term performance); Fried, *supra* note 6 (arguing that focus on long-term value can reduce economic value for

disclosure to a semiannual or annual basis would do little to check the problem. Reducing mandatory disclosure would likely increase the volatility of stock prices, reduce liquidity, and increase insider trading.[12]

But the short-termism objection to quarterly disclosure is worth analyzing because it raises the interesting question of whether policies to protect investors, which have generally been uncontroversial, can have a negative impact on corporate decision-making. The fact that securities regulators in other jurisdictions have rejected mandatory quarterly disclosure on short-termism grounds raises the possibility of a flaw in the U.S. approach.[13] Core aspects of securities regulation may have a broad negative impact on the governance of public companies.

This Article contributes to the debate about the frequency of periodic disclosure by tracing the origins of quarterly reporting. The modern *quarterly reporting system* has two components.[14] First, the securities laws mandate *quarterly disclosure* for public companies. Second, investors judge the results reported in such disclosure in relation to *quarterly projections* of financial results. Rather than looking solely at the *frequency* of disclosure as the cause of short-termism, this Article examines how other factors, such as the *reliability* of disclosure and evaluation of disclosure through *projections*, are important contributors.

The quarterly reporting system reflects a closely intertwined blend of government regulation and private ordering. Both quarterly disclosure and quarterly projections originated independently from SEC regulation. Quarterly disclosure of earnings was required by the New York Stock Exchange (NYSE) decades before the SEC mandated it in 1970. Projections, which are typically issued by research analysts, became common in the 1960s, at a time when SEC policy sought to discourage them. Since the late 1970s, the SEC has reinforced the legitimacy of a

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a corporation that transacts in its own shares); Michal Barzuza & Eric Talley, *Long-Term Bias* (ECGI Working Paper Series in Law, Paper No. 449, 2019), https://www.ssrn.com/abstract=3338631 [https://perma.cc/3HTA-8ZU9] (arguing that long-term bias where "managers systematically overestimate the value of their own long-term projects" is of equal concern as short-term bias).

12. Disclosure has many benefits that have been well-documented. *See, e.g.*, Merritt B. Fox et al., *Law, Share Price Accuracy, and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331, 339–40 (2003) (describing benefits of disclosure); Renhui Fu et al., *Financial Reporting Frequency, Information Asymmetry, and the Cost of Equity*, 54 J. ACCT. & ECON. 132 (2012) (finding that increase in interim reporting frequency reduced information asymmetry and the cost of equity).

13. The EU and some other jurisdictions have rejected mandatory quarterly disclosure on the ground that it promotes short-termism. *See, e.g.*, Sanjeev Bhojraj & Robert Libby, *Capital Market Pressure, Disclosure Frequency-Induced Earnings/Cash Flow Conflict, and Managerial Myopia*, 80 ACCT. REV. 1 (2005); *see also* JOHN KAY, THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING 9 (2012) (concluding that "short-termism is a problem in UK equity markets").

14. The point that the reporting system is broader than "simply reporting numbers" has been long recognized. *See, e.g.*, A.A. Sommer, Jr., *An Overview of the Issues*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS 1, 8 (Prem Prakash & Alfred Rappaport eds., 1974) (noting that "financial reporting" encompasses disclosure and "also the stating of information that is necessary for meaningful interpretation of the numbers, it means projecting and forecasting future developments").

system that judges companies based on their quarterly results. For example, it has emphasized the importance of issuing quarterly disclosure that accurately reflects whether a company has met market projections.

The evidence most clearly points to projections as the main source of pressure on public companies. Public companies reported quarterly earnings for decades without feeling the pressure of short-termism. It was not until quarterly projections became widely distributed that short-termism became an issue. By the late 1990s, quarterly projections were linked to fraud where companies destroyed long-term value to deliver short-term performance. More recently, public company managers report that they are willing to cut R&D expenditures to meet a projection.

It is important to acknowledge that projections should only create problematic short-term pressure on managers in certain situations. If market expectations are too high, managers can convey that projections should be lowered. On the other hand, managers can have an incentive to strive to meet unrealistically high projections. If they cannot generate sufficient performance to meet such projections, they may resort to measures that boost short-term performance but destroy long-term value.

If projections are the main source of short-termism, reform should be directed at such projections rather than taking the more radical step of reducing quarterly disclosure. Increasing the obligation of public companies to provide their own projections and the assumptions behind such projections might reduce the risk that they are judged by unrealistic expectations. While relaxing requirements about the reliability of quarterly results could reduce the pressure of the quarterly reporting system, doing so would also adversely affect its integrity. Modest reform is warranted given the limited evidence that public companies are sacrificing substantial long-term value. The quarterly reporting system likely tilts public companies broadly towards short-termism, but it is unclear that the degree of such pressure is severe.

The impact of the quarterly reporting system on the management of public corporations may be muted because corporate law emphasizes different considerations than securities law. Because securities regulation primarily facilitates securities transactions,[15] it generally favors short-term investors who purchase and sell securities more frequently than long-term investors. In contrast, rather than focusing on the narrow interests of investors when transacting, corporate law more broadly governs the interests of investors while they own a stock.

The dispersed shareholders of public companies have famously been described as weak relative to company managers.[16] As securities regulation has evolved to meet the needs of markets that have become more liquid and demanding over time, the power of shareholders has increased. Managers have been able to

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15. *See, e.g.*, James J. Park, *Reassessing the Distinction Between Corporate and Securities Law*, 64 UCLA L. REV. 116 (2017) (arguing that the securities laws focus on transactions).

16. *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS (1996).

resist stronger securities law because corporate law gives them discretion to consider the long-term interests of the corporation. To an extent, weaker corporate law favoring managerial discretion is a way of addressing the tendency of securities law to favor transacting investors. Put another way, strong securities law can be balanced by weak corporate law.

Part I of this Article describes the origins of the modern quarterly reporting system. Part II examines how the quarterly reporting system affects the incentive of public corporations and investors to focus on short-term results. Part III weighs proposals for reforming the quarterly reporting system to check short-termism. Part IV concludes by showing how the short-termism promoted by securities law has been checked by corporate law, which gives managers discretion to consider the long-term interests of the company.

I. THE ORIGINS OF THE QUARTERLY REPORTING SYSTEM

The problem of short-termism did not immediately commence with the SEC's creation of Form 10-Q in 1970. A quarterly disclosure mandate by itself was not enough to significantly affect managerial time horizons. Many public corporations disclosed earnings results on a quarterly basis before 1970, but such quarterly disclosure was not viewed as incentivizing public companies to focus on the short term. It was not until company filings became more reliable and commonly judged by projections that managerial incentives were significantly impacted by the quarterly reporting system.

Pressure to deliver financial results began to emerge as investors increasingly relied on projections in assessing company performance.[17] By the end of the 1960s, a significant number of analysts attempted to predict the yearly earnings of major public companies. Despite the SEC's policy of prohibiting companies from including projections in their filings with the agency, some companies released their own projections, and many selectively disclosed information to analysts to shape expectations about their future performance. By the mid-1980s, quarterly earnings projections were widely dispersed and used by markets to assess managerial competence. As quarterly results became more important over the course of the 1990s, the SEC increased its expectations about the accuracy of such results, reinforcing the pressure to meet short-term projections.

17. The link between investor preferences and short-termism has been widely acknowledged. *See, e.g.*, Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1764 (2006) (arguing that "increasing sway of institutional investors over corporations" resulted in focus on growing earnings that caused corporate scandal); *see also* MATTEO TONELLO, THE CONFERENCE BOARD, REVISITING STOCK MARKET SHORT-TERMISM 6 (2006) (linking short-termism to rise of institutions and changes in tax policies that made short-term trading more profitable).

The modern quarterly reporting system thus arose through a combination of government mandate and private ordering. Quarterly disclosure that became more reliable over time through SEC regulation interacted with projections that originated primarily from private research analysts.

A. Quarterly Disclosure

Many public companies issued quarterly disclosure for decades before it was mandated by the SEC, but the earliest versions of such disclosure were not viewed as trustworthy. For a variety of reasons, starting in the 1970s, the SEC sought more uniformity and accuracy with respect to quarterly filings. It was not until periodic disclosure became sufficiently reliable that it could be used to systematically assess the financial performance of companies.

1. A Signal of Quality

Prior to 1970, many public companies listed on exchanges provided quarterly reports to investors. The NYSE had required such disclosure of all listed companies since the 1930s,[18] though it gave companies significant discretion in what they would report.

As many scholars have observed, stock exchanges, which provide a liquid and orderly market for trading in a company's stock, have an economic incentive to develop regulation that facilitates trading.[19] Exchanges generate much of their revenue by charging commissions for executing trades. If companies listed on an exchange do not provide enough information to the market, investors will trade less because they will not be confident that their trades are made at a reasonable valuation. On the other hand, if exchanges require too much regulation of companies, more companies will choose not to list their stock on the exchange. Exchanges must balance the interests of investors and public companies. In a sense, their rules are meant to reflect the agreement that these parties would negotiate.[20]

The NYSE's early mandate of quarterly disclosure was a way of differentiating itself from competitors. Its primary rival, the American Stock Exchange (AMEX), did not require quarterly disclosure until 1962.[21] Public companies of higher quality are both able to invest resources in reporting and more confident in sharing details about their performance. With its comparatively stringent listing standards, the

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18. *See Exchange Encourages Interim Financial Reports*, NEW YORK STOCK EXCHANGE BULLETIN, Aug. 1939, at 2; *see also* GILBERT W. COOKE, THE STOCK MARKETS 216 (1964).

19. *See, e.g.*, Stuart Banner, *The Origin of the New York Stock Exchange, 1791–1860*, 27 J. LEGAL STUD. 113 (1998); Paul G. Mahoney, *The Exchange As Regulator*, 83 VA. L. REV. 1453, 1457 (1997); A.C. Pritchard, *Markets As Monitors: A Proposal to Replace Class Actions with Exchanges As Securities Fraud Enforcers*, 85 VA. L. REV. 925, 963–81 (1999).

20. *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1996).

21. *See, e.g.*, Richard W. Leftwich et al., *Voluntary Corporate Disclosure: The Case of Interim Reporting*, 19 J. ACCT. RES. 50, 52–54 (1981) (describing the evolution of exchange disclosure requirements).

NYSE could signal that its companies were better investments than stocks listed on other exchanges.[22] The AMEX's niche was smaller companies that did not meet the higher standards of the NYSE but might be attractive to investors willing to take on more risk.[23] By choosing to list with the NYSE, companies could differentiate themselves from less reputable firms.

Even before the securities laws mandated quarterly disclosure, public investors had access to quarterly earnings data for major public companies. At least a decade before the SEC released Form 10-Q, the *Value Line Investment Survey* published quarterly financial information in chart form for about a thousand companies. An investor could look at the January 1963 issue and find tabular quarterly sales and earnings per share information for hundreds of public companies from the start of 1957 through the end of 1962.[24]

Many public companies were thus reporting quarterly results decades before short-termism emerged as a problem. As has been well-documented, the period spanning the 1950s through the 1960s was characterized by significant deference to corporate managers.[25] Large public companies were not as scrutinized by investors and felt they had the discretion to consider the interests of all corporate stakeholders rather than just shareholders.[26] They had a long-term rather than a short-term perspective. As the management guru Peter Drucker wrote in 1954, "every basic management decision is a long-range decision—with ten years a rather short time-span in these days."[27] Despite the fact that many public companies released quarterly earnings results to the market, they did not feel compelled to focus on short-term performance.

Rather than fixate on quarterly results, investors evaluated a company's earnings over longer periods. As Warren Buffet's teacher, the Columbia professor Benjamin Graham, noted in the 1973 edition of the *Intelligent Investor*: "[I]nvestors paid considerable attention to the average earnings over a fairly long period in the past—usually from seven to ten years. This 'mean figure' was . . . thought to give a

22. *See, e.g.*, Van Gemert v. Boeing Co., 520 F.2d 1373, 1381 (1975) ("[T]o the American investing public listing on the New York Stock Exchange carries with it implicit guarantees of trustworthiness.").

23. *See, e.g.*, HILLEL BLACK, THE WATCHDOGS OF WALL STREET 223 (1962) (describing the American Stock Exchange "as a seasoning ground for new companies"); ROBERT SOBEL, THE CURBSTONE BROKERS 21–40 (1970) (describing rivalry between exchanges).

24. *See* VALUE LINE, COMPLETE OVERVIEW: THE VALUE LINE INVESTMENT SURVEY 4 (1963).

25. *See, e.g.*, Jack B. Jacobs, *"Patient Capital": Can Delaware Corporate Law Help Revive It?*, 68 WASH. & LEE L. REV. 1645, 1647 (2011) (describing post-war period where "[w]ith relatively few exceptions, no one pressured corporate managements to run their companies from quarter to quarter to meet the expectations of stock analysts or institutional shareholders, and only rarely were there efforts to pressure managers to manage for the short-term by threatening to oust them from office").

26. *See, e.g.*, ROBERT AARON GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION xii (5th prtg. 1961) (noting that "the maintenance of satisfactory profits is a more accurate statement of the profits objective than is complete profits-maximization").

27. PETER F. DRUCKER, THE PRACTICE OF MANAGEMENT 88 (1954).

better idea of the company's earning power than the results of the latest year alone."[28] The stock market for a time thus did not pressure public companies to generate quarterly or even annual results.

Even after they were initially required, there was skepticism about whether quarterly disclosure conveyed reliable information. When the NYSE first mandated them in 1939, it warned that such reports "cannot represent more than the most accurate estimates possible" because "[t]hree months are considered by corporations in some fields of business as too short a period within which to attempt to approximate costs with accuracy or finality."[29] The preparation of disclosure requires an inevitable "element of judgment" that "must be multiplied many fold in the case of quarterly statements."[30] Without confidence in their reliability, for decades, quarterly reports were not viewed as a way of accurately measuring the performance of companies.

Thus, the frequency of disclosure by itself could not have been the sole cause of corporate short-termism. It was not until the market could trust the information in such disclosure that they became the basis for judging the performance of public companies.

2. Uniformity and Reliability

Over time, SEC regulation shaped quarterly disclosure so it could eventually become the primary metric for judging company performance. The SEC did not intend to create a system that would pressure companies to continually satisfy investor expectations. But its policies of protecting investors from fraud and facilitating the efficiency of markets have had the effect of influencing the decision-making horizons of public company managers.

At least initially, the federal securities laws did not substantially supplement the disclosure practices of exchanges. The primary regulatory concern was the sale of securities, especially by unproven businesses. Over time, the SEC turned to the disclosure practices of established public companies. The SEC became more concerned with ensuring that trading in secondary markets that set the value for a public corporation's stock was based on uniform and reliable information.

A series of SEC studies of securities markets starting in the 1940s found higher rates of fraud and lower levels of disclosure for companies that were not traded on an exchange.[31] Until 1964, such over-the-counter companies were not even subject to annual periodic disclosure requirements. The Securities Exchange Act of 1934, which requires such additional disclosure, initially only applied to companies listed on an exchange. This gap in regulation created the opportunity for regulatory

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28. BENJAMIN GRAHAM, THE INTELLIGENT INVESTOR 172 (4th rev. ed. 1973).

29. *Exchange Encourages Interim Financial Reports*, *supra* note 18, at 2.

30. *Id.*

31. Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 34–45 (1983) (describing findings of SEC studies).

arbitrage. The ability to avoid regulation by delisting from an exchange limited the ability of stock exchanges to mandate quality disclosure of listed companies.[32]

The SEC's first move in regulating periodic disclosure was to require uniformity in the disclosure practices of all public companies, regardless of whether they traded on a stock exchange. The Securities Acts Amendments of 1964 applied the disclosure requirements of the Exchange Act to any company exceeding minimum thresholds of investors and assets.[33] Thus, companies that may not have qualified for exchange listings or were purposely not listing to avoid regulation were now subject to periodic disclosure regulation.

By eliminating an opportunity for regulatory arbitrage, the SEC laid the foundation for increasing the frequency of reporting. Until 1970, the SEC only required public companies to file disclosures on a semiannual basis.[34] As the system was described in 1966: "[F]irst in importance is an annual report (Form 10-K under the 1934 Act, for most issuers) . . . containing certified financial statements . . . . Second, there is a required semiannual report (Form 9-K) containing a few basic financial data, on an uncertified basis."[35]

After an extensive study of the disclosure practices of public companies by SEC Commissioner Francis Wheat found that the quality of the quarterly reports mandated by stock exchanges was not uniform,[36] the SEC promptly moved to take control of quarterly disclosure. The SEC considered a continuous disclosure system, where companies would be required to promptly disclose any material information but rejected it as "unduly burdensome and duplicative of the timely disclosure policies of the major stock exchanges."[37] It thus settled on the compromise of quarterly disclosure of company information. Notably, unlike the prior semiannual

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32. *See* SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 62 (1969) [hereinafter WHEAT REPORT].

33. Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964) (codified as amended at 15 U.S.C. §§ 77d, 78c, 78l–78o, 78o-3, 78p, 78t, 78w, 78ff (2012)).

34. From 1945 until 1953, the SEC required quarterly disclosure of sales and revenue of public companies. *See* Notice of Proposed Adoption of Form 9-K and Rules X-13A-13 and X-15D-13, Securities Act Release No. 33-3529, Exchange Act Release No. 34-5129 (Jan. 27, 1955). The early attempts to mandate quarterly disclosure were resisted by managers and supported by analysts who reported difficulty in obtaining quarterly sales information from companies. *See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1549 (2007) (citing 2 LOUIS LOSS, SECURITIES REGULATION 809–57 (2d ed. 1961)).

35. Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1356–57 (1966); *see also* Adoption of Form 9-K and Rules X-13A-13 and X-15D-13, Securities Act Release No. 33-3553, Exchange Act Release No. 34-5189 (June 23, 1955). In addition, companies were required to file interim disclosures on Form 8-K for specified events. *See* Cohen, *supra*, at 1357.

36. WHEAT REPORT, *supra* note 32, at 39 ("It was readily apparent (and acknowledged by representatives of the exchanges) that they varied from extremely useful to extremely poor and uninformative."); *see also* Cohen, *supra* note 35, at 1363 ("The contents of such interim reports are not prescribed in any detail, and the full disclosure standards of the federal statutes do not apply.").

37. Proposal to Adopt Form 10-Q Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 and to Rescind Forms 8-K and 9-K under that Act, Exchange Act Release No. 34-8683 (Sept. 15, 1969).

Form 9-K disclosures, the new Form 10-Q would have to be "prepared in accordance with generally accepted accounting principles and practices on a consistent basis."[38]

These new regulatory requirements reflected a change in the demands of investors who essentially negotiated a new contract with public companies. The increase in periodic disclosure coincided with substantial changes in securities markets and their participants.[39] Institutional investors had become more prominent and some of them traded more frequently than retail investors. One explanation for the SEC's new policy is that it sought to meet the needs of such investors.

In addition to uniformity, federal regulation has sought to improve the reliability of securities disclosure. Until the 1970s, the most important disclosure document was the registration statement filed by a company when it sold securities.[40] This registration statement was subject to high standards of accuracy enforced by Section 11 of the Securities Act,[41] which prohibits any material misrepresentation in a registration statement. In contrast, the securities laws did not initially require as much for periodic disclosure reports.[42] As Milton Cohen wrote in a famous article on the disclosure system published in the *Harvard Law Review*, "the disclosure process under the 1934 Act . . . appears never to have been taken quite as seriously under the 1933 Act, very likely because of differences in the attendant liabilities and sanctions and in Commission procedure."[43]

In the wake of a wave of foreign bribery scandals by public companies in the mid-1970s,[44] Congress questioned how an established public company could make payments to win foreign business that were not reflected in its financial statements. It passed a statute, the Foreign Corrupt Practices Act of 1977,[45] which requires that

38. Adoption of Form 10-Q, Rescission of Form 9-K and Amendment of Rules 13a-13 and 15d-13, Securities Exchange Act Release No. 34-9004 (Oct. 28, 1970). There was no such requirement for Form 9-K. *See* Adoption of Form 9-K and Rules X-13A-13 and X-15D-13, *supra* note 35.

39. *See, e.g.*, WILLIAM MCCHESNEY MARTIN, JR., THE SECURITIES MARKETS 44 (1971) (noting changes in markets that resulted in an "unexpected syndrome of go-go speculation for short-term performance").

40. Securities Act of 1933 § 5, 15 U.S.C. § 77g (2012).

41. *Id.* § 77k.

42. For example, the Wheat Report expressed the view that quarterly earnings statements would not trigger liability for misrepresentations because they reported estimates. *See* WHEAT REPORT, *supra* note 32, at 339.

43. Cohen, *supra* note 35, at 1361; *see also* Gordon, *supra* note 34, at 1550 (noting that the SEC "sought to ratchet up the 1934 Act periodic filings to the same depth and currency as would be expected of a 1933 Act registration statement"). At the time he wrote, it was unclear whether Rule 10b-5 reached misstatements by public companies relating to their ongoing condition. *See, e.g.*, Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951) (rejecting claim that secondary market investor was defrauded by corporation because of a lack of privity).

44. *See* SEC, REPORT OF THE SEC. & EXCH. COMM'N ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES (1976).

45. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (codified as amended in scattered sections of 15 U.S.C.).

the books and records of a public company "accurately and fairly" describe company transactions.[46] It also mandates that public corporations have a system of internal controls to help ensure the reliability of their financial statements.[47] These new requirements increased the expectation that periodic disclosure, including quarterly reports, would be accurate. Decades later, the Sarbanes-Oxley Act built upon this foundation to mandate the yearly assessment and certification of the effectiveness of such internal controls.[48]

The quarterly reports that were filed on Form 10-Q became successful enough in providing uniform disclosure to markets that by the early 1980s, the SEC found it unnecessary to require established public companies to file extensive disclosures when selling additional securities to the public.[49] Instead of filing a full registration statement for such a sale, a seasoned corporation could simply refer investors to its periodic reports. Such information would have been incorporated into the stock price by markets, making a new filing unnecessary.[50] Without quarterly filings that were expected to conform to a standard of accuracy, there would have been a stronger case that investors would need an update of information that had been filed as part of the company's annual 10-K or its last registration statement. One uniform rule, Regulation S-K,[51] set forth requirements that made the information disclosed in the 10-Q and 10-K equivalent to that disclosed in the initial registration statement filed by a company going public.

As periodic disclosure became more uniform and reliable, investors were better able to assess the performance of a company. A corporation's current results could be compared to prior results with some assurance that both were prepared using the same methodology. A corporation's financial reports could also be evaluated relative to the reports of similar companies with greater confidence. The market could efficiently process this information to assess a company's value.

B. *Quarterly Projections*

By the late 1970s, quarterly disclosure was an established requirement for all public companies and subject to basic standards of reliability. It took another decade

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46. Securities Exchange Act of 1934 § 13(b)(2)(A), 15 U.S.C. § 78j(b) (2012).

47. *Id.*

48. Sarbanes-Oxley Act § 404, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

49. Instead, they could file an abbreviated registration statement that incorporates by reference the company's periodic reports. *See* Adoption of Integrated Disclosure System, Securities Act Release No. 6383, Exchange Act Release No. 18524 (Mar. 3, 1982); Shelf Registration, Securities Act Release No. 6499, Exchange Act Release No. 20384 (Nov. 17, 1983).

50. There were different opinions at the time as to whether Exchange Act filings were sufficiently reliable. *Compare* Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984) (arguing that due diligence of quarterly reports was unnecessary in an efficient market), *with* Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005 (1984) (arguing that due diligence might be necessary).

51. Reg. S-K, 17 C.F.R. § 229.10–229.702.

for the pressure to generate quarterly results to become systematic. It was not until quarterly projections used to assess a company's performance became widely dispersed and utilized that companies began to feel the need to continually deliver short-term results.

1. The Emergence of Quarterly Projections

Research analysts who closely follow and evaluate public companies are an important part of what Professors Ronald Gilson and Reinier Kraakman famously called the mechanisms of market efficiency.[52] As recognized by the SEC and the U.S. Supreme Court,[53] analysts are critical information processors that are essential for stock markets to function efficiently. An important way that research analysts influence a company's stock price is by publishing earnings projections predicting a company's financial results.[54]

Starting in the 1960s, analysts increasingly began seeking information from companies that would allow them to better forecast their earnings.[55] Large corporations had long generated their own internal budgets and projections to manage their operations.[56] Over time, it was not difficult for these forecasts to migrate outside of the corporation's walls.[57] Even as the legality of insider trading became more questionable, information relating to market forecasts was often

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52. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

53. *See, e.g.*, Dirks v. SEC, 463 U.S. 646, 658–59 (1983).

54. While companies can also release their own earnings projections, a substantial percentage of companies do not. *See, e.g.*, Anne Beyer et al., *The Financial Reporting Environment: Review of the Recent Literature*, 50 J. ACCT. & ECON. 296, 313 (2010) (reporting that the percentage of firms providing public earnings forecasts increased from 10–15% in the mid-1990s to 50% in 2004).

55. Even before the rise of public companies, forecasting was an essential part of business. *See, e.g.*, PETER L. BERNSTEIN, AGAINST THE GODS: THE REMARKABLE STORY OF RISK 95 (1998) (noting that "forecasting—long denigrated as a waste of time at best and a sin at worst—became an absolute necessity in the course of the seventeenth century for adventuresome entrepreneurs who were willing to take the risk of shaping the future according to their own design").

56. As documented by the business historian Alfred D. Chandler, as early as 1906, the DuPont company systematically prepared and used internal forecasts that were "checked regularly against actual results." ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 449 (1977). Companies like General Motors soon followed. ALFRED D. CHANDLER, JR., STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF INDUSTRIAL ENTERPRISE 145–53 (2d prtg. 1963).

57. In a sense, internal projections are a part of what economists refer to as internal capital markets. *See, e.g.*, Jeremy C. Stein, *Internal Capital Markets and the Competition for Corporate Resources*, 52 J. FIN. 111 (1997) (assessing conditions when internal capital markets are efficient). When managers are better monitors of projects than markets, it can be efficient for them to allocate funds to the most promising projects within the firm, rather than going to external investors to fund those projects. *See, e.g.*, George G. Triantis, *Organizations As Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1105 (2004) ("The distinction between external and internal capital markets is that capital moves between projects by contract in the former case and by authority or fiat in the latter.").

selectively disclosed to analysts.[58] More companies also began publicly disclosing their own projections during this period.[59]

At a conference on public reporting of projections held at Northwestern University in 1971, the CEO of the retailer J.C. Penney described how the company came to issue projections. Prior to 1963, J.C. Penney's business was relatively simple, and it "furnished only the most basic historical information" to analysts.[60] As it began to expand and diversify, the company found that "analysts were less able to develop a satisfactory evaluation of Penney on the basis of the rather scanty information which had satisfied them in the past."[61] J.C. Penney thus began developing forecasts based on its internal budgets,[62] which "include projections of sales [and] earnings" that "were developed solely for management planning and control purposes" but had become "desirable for external reporting purposes."[63]

These initial projections were typically of a company's yearly rather than quarterly earnings. Starting in 1967, Standard & Poor's began publishing a weekly publication called the *Earnings Forecaster* that listed multiple analyst forecasts for about a thousand public companies.[64] For the typical company, the *Earnings Forecaster* would report the actual earnings for the most recent year as well as forecasts for the annual earnings for the next two years. By July 1970, the *Earnings Forecaster* included in a separate section analyst decisions to revise prior projections upwards or downwards.[65]

The emergence of projections coincided with and perhaps reflected a shift in the way that markets valued companies. When the original federal securities laws were passed, investors primarily focused on assessing the value of a company's assets. As Professor Paul Mahoney has shown, Congress in the 1930s was mainly concerned with promoters who issued stock backed by assets that were assigned arbitrarily high values.[66] Moreover, a lack of uniformity in accounting principles

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58. An article published in 1967 noted that while the SEC prohibited projections, "[c]ompany officials, however, are often confronted with projections made by brokerage firms and investment banking houses and asked to confirm the figures." Arthur Fleischer, Jr., *Corporate Disclosure/Insider Trading*, 45 HARV. BUS. REV. 129, 134 (1967).

59. *See, e.g.*, Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1199 (1970) ("The professionals get management projections informally through press conferences, speeches to analysts' societies or press releases, and these projections form the basis for professional judgments."); James M. Patell, *Corporate Forecasts of Earnings Per Share and Stock Price Behavior: Empirical Tests*, J. ACCT. RES. 246 (1976) (studying 336 voluntary forecasts issued by companies through the *Wall Street Journal* from 1963 to 1967).

60. Kenneth S. Axelson, *An Executive's Views on the Forecasting of Earnings*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 14, at 35, 35.

61. *Id.*

62. J.C. Penney began compiling systematic budgets in the early 1960s. *See* Isadore Barmash, *Penney-Pinching: Budget Process Detailed and Long*, N.Y. TIMES, Feb. 20, 1972, at F1.

63. Axelson, *supra* note 60, at 37.

64. *See* STANDARD & POOR'S, EARNINGS FORECASTER (Jan. 6, 1967).

65. *See* STANDARD & POOR'S, EARNINGS FORECASTER (July 3, 1970).

66. PAUL G. MAHONEY, WASTING A CRISIS: WHY SECURITIES REGULATION FAILS 46–48 (2015).

until the 1970s made it difficult to rely upon earnings results that could serve as the basis for forecasting future performance.[67] Indeed, for decades, financial statements were not meant to inform the decisions of investors.[68]

Over time, investors definitively recognized that the value of a company's equity is the present value of the company's future earnings. As one commentator observed with respect to the bull market of the late 1950s, which featured electronics and high technology issues, investors were willing to price such companies based "not on current earnings or past performance but on projections."[69] A 1972 article in the *Harvard Business Review* noted the "appearance of new security analysis models" and that "[s]hifting from balance-sheet-oriented book and liquidation value approaches, investors have reached a nearly unanimous perception that the value of the common stock—whether viewed in terms of multiples of earnings or more sophisticated concepts—is the present worth of future earnings available to the stock."[70]

As sophisticated investors and analysts relied on such models to assess the value of their investments,[71] projections became more useful to them in predicting a company's future earnings. The increasing importance of projections in valuation is illustrated by revisions to the classic *Security Analysis* text by Benjamin Graham and David Dodd. Through its second edition, which was published in 1940, there was no chapter on earnings projections, though there was a chapter on the "Significance of the Earnings Record."[72] Beginning with the third edition published in 1951, the title of that chapter was changed to include the phrase: "Projections of Earnings and Dividends."[73] This chapter was then significantly expanded in the fourth edition published in 1962.[74]

The increasing dissemination of projections by public companies was in tension with the SEC's negative views on the disclosure of forward-looking

67. *See* Ray Ball & Philip Brown, *An Empirical Evaluation of Accounting Income Numbers*, 6 J. ACCT. RES. 159, 160 (1968) (observing that "[b]ecause accounting lacks an all-embracing theoretical framework, dissimilarities in practice have evolved. As a consequence, net income is an aggregate of components which are not homogenous. It is thus alleged to be a 'meaningless' figure, not unlike the difference between twenty-seven tables and eight chairs.").

68. *See* Jack L. Treynor, *The Trouble with Earnings*, 28 FIN. ANAL. J. 41, 41 (1972) ("Informing the analyst was not always a primary or even a secondary objective of financial accounting, nor were accounting outputs always the primary input for securit[ies] analysis . . . .").

69. ROBERT SOBEL, N.Y.S.E.: A HISTORY OF THE NEW YORK STOCK EXCHANGE, 1935–1975, at 235 (1975).

70. *See* Henry B. Reiling & John C. Burton, *Financial Statements: Signposts As Well As Milestones*, HARV. BUS. REV. 45, 46 (1972).

71. By the late 1960s, professional managers and research analysts had become influential in setting securities prices. *See* WHEAT REPORT, *supra* note 32, at 10.

72. BENJAMIN GRAHAM & DAVID L. DODD, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES 472 (2d ed. 1940).

73. BENJAMIN GRAHAM & DAVID L. DODD, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES 412 (3d ed. 1951).

74. BENJAMIN GRAHAM & DAVID L. DODD, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES 450 (4th ed. 1962).

information. Though it did not have a formal ban on projections, the SEC had a longstanding policy of prohibiting companies from including projections in official SEC filings.[75] This policy was based on the assumption that "attempts by companies to predict future earnings on their own or on the authority of experts have almost invariably been held by the Commission to be misleading because they suggest to the investor a competence and authority which does not in fact exist."[76] The SEC's position was consistent with its philosophy of protecting investors from fraudulent schemes that often relied on promises of future performance with little hope of success, but this stance began to look anachronistic as analysts and sophisticated investors commonly used valuation models that relied on projections of future earnings.[77] Such predictions also may have seemed safer for established public companies trading in active markets than for new companies without an operating history.

Even prior to the SEC's mandate of quarterly disclosure, markets started to harshly judge some companies for failing to meet market expectations. For example, in the late 1960s, when Litton Industries, a prominent conglomerate, announced that its quarterly earnings would be lower than the prior year's earnings, there was a significant negative market reaction that was widely noted.[78] Such large public companies were believed to continually deliver increasing earnings, partly because of the prowess of their management and clever diversification of holdings, and the failure to do so "was taken by investors to mean that Litton—the very symbol of all that is modern in management—was indeed subject to seriously inadequate management."[79]

While initially the norm was for analysts to issue forecasts of annual earnings, eventually it became common for analysts to issue projections of quarterly results.[80]

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75. As Harvard Law School Professor Victor Brudney explained, "[t]he Commission's opposition was expressed in admonitory releases and in opinions in particular cases more than in any general prohibitory regulation under the Securities Act." Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 753, n.80 (1989).

76. Harry Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 BUS. LAW. 300, 307 (1961); *see also* Patell, *supra* note 59 (describing debate about the usefulness of forecasts).

77. By 1969, the Wheat Report concluded that research analysts "are in the business of estimating the present and future value of securities based on predictions of sales and earnings." The Report thus concluded that "most investment decisions are based essentially on estimates of future earnings." WHEAT REPORT, *supra* note 32, at 95.

78. *See* JOHN BROOKS, THE GO-GO YEARS: THE DRAMA AND CRASHING FINALE OF WALL STREET'S BULLISH 60S, at 181 (1999); William S. Rukeyser, *Litton Down to Earth*, FORTUNE, Apr. 1968, at 139. Other companies in the 1960s suffered negative stock price reactions for failing to meet market estimates. *See, e.g.*, Fin. Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 515 (10th Cir. 1973) (noting substantial decline in McDonnell Douglas stock after it reported semiannual earnings significantly below estimates).

79. William S. Rukeyser, *Litton Down to Earth*, *in* THE CONGLOMERATE COMMOTION 109, 110 (1970).

80. Even for projections of yearly earnings, there was concern that forecasts would encourage short-term trading. *See, e.g.*, William S. Gray III, FAF Special Comm. on Corp. Forecasts, *Proposals by the Federation for Systematic Disclosure of Corporate Forecasts*, *in* DISCLOSURE OF CORPORATE FORECASTS TO THE INVESTOR 1, 70 (Financial Analysts Federation, ed. 1973) ("There is considerable

The Institutional Brokers' Estimate System, also known as I/B/E/S, began compiling analyst quarterly projections that were available through a computer database starting in 1984.[81] By the late 1980s, a magazine profile of a research analyst noted that her "constant task is to predict per-share profits in three-month increments."[82] Even as quarterly projections became more prevalent, one journalist reported that at the mutual fund giant Fidelity there was not much emphasis on companies meeting specific projections through the late 1980s.[83] During that period, he never heard an analyst note that a company "exceeded expectations" or ask whether a company would "make the quarter."[84]

As financial data companies began to more systematically compile and disseminate consensus earnings projections in the early 1990s,[85] they became an easy heuristic that could be used for assessing a public company's performance.[86] There is evidence that by the mid-1990s, investors began to reward companies for meeting quarterly earnings projections.[87] As projections became more important, companies had a greater incentive to meet them. One study found that the

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fear among investors that more frequent management forecasts would tend to induce more emphasis on short term trading."); Prem Prakash & Alfred Rappaport, *Synthesis of Discussion Public Reporting of Corporate Financial Forecasts: Some Perspectives*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 14, at 189, 191 (noting risk that "[t]he presentation of a one-year earnings forecast would give impetus to short-term market trading in place of investment with an eye toward longer term prospects.").

81. *See, e.g.*, Douglas J. Skinner & Richard G. Sloan, *Earnings Surprises, Growth Expectations, and Stock Returns or Don't Let an Earnings Torpedo Sink Your Portfolio*, 7 REV. ACCT. STUD. 289, 294 (2002) (using I/B/E/S quarterly data starting in 1984). This service started compiling forecasts in 1972. *See* Samuel S. Stewart, Jr., *Research Report on Corporate Forecasts*, *in* DISCLOSURE OF CORPORATE FORECASTS TO THE INVESTOR, *supra* note 80, at 75, 126.

82. Joseph Nocera, *Picking the Winners*, N.Y. TIMES MAG., Sept. 20, 1987, at 26, 30; *see also* Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21, 26 (1988) (noting "major . . . pressure on corporations to generate high current earnings on a quarter-to-quarter basis.").

83. Joseph Nocera, *The Trouble with the Consensus Estimate*, MONEY, June 1998, at 59, 59–60.

84. *Id.*

85. *See, e.g.*, *id.* (describing how the company First Call began disseminating projections electronically in 1990); *see also* ALEX BERENSON, THE NUMBER: HOW THE DRIVE FOR QUARTERLY EARNINGS CORRUPTED WALL STREET AND CORPORATE AMERICA 167 (2003) (finding that *Wall Street Journal* articles mentioning the words "consensus" and "estimates" and "earnings" tripled between 1989 and 1994 and increased tenfold from 1994 to 1999).

86. Meeting a projection is only one of a number of potential thresholds that the market can look to in assessing performance. One study describes three such thresholds: (1) sustaining recent performance; (2) meeting analyst forecasts; and (3) reporting profits. Of these three, there is evidence that the third threshold is most important. *See* Francois Degeorge et al., *Earnings Management to Exceed Thresholds*, 72 J. BUS. 1 (1999).

87. Professors Brown and Caylor documented the impact of quarterly earnings reports issued from 1984 to 2002. They concluded that "since the mid-1990s, but not before then, investors unambiguously reward[ed] . . . firms . . . for reporting quarterly earnings meet[ing] . . . analysts' estimates . . . ." Lawrence D. Brown & Marcus L. Caylor, *A Temporal Analysis of Quarterly Earnings Thresholds: Propensities and Valuation Consequences*, 80 ACCT. REV. 423, 425 (2005).

probability of a company meeting a quarterly projection increased from 40% in 1985 to 70% in 1997.[88]

2. The SEC's Support of Projections

The influence of the securities laws on projections of company earnings is not immediately apparent. As noted earlier, quarterly projections originated in market practices rather than government regulation. Even though it no longer prohibits earnings projections in its filings, the SEC has never required public companies to issue them. Yet SEC policy has often supported the current system that emphasizes meeting such projections.

By the late 1970s, partly because of the reality that projections were already being widely used, the SEC reversed its policy of discouraging company projections upon the recommendation of an Advisory Committee on Disclosure.[89] A significant motivation for the new policy was to provide public investors with access to projections that companies released privately to analysts and select investors.[90] Another rationale was that as companies became more sophisticated in developing internal budgets, there was greater confidence that forecasts would be reliable.[91] The SEC not only reversed its prohibition, it actively sought to encourage companies to issue forward-looking statements.[92] In the late 1970s, it passed a safe harbor rule that provided some protection for companies issuing written projections from securities fraud liability.[93] This safe harbor was meant to address the concern of companies that they would be sued by investors suffering losses if they issued a projection and failed to meet it.

This initial safe harbor was unsuccessful because it only provided protection for projections made in good faith and with a reasonable basis. It also only applied to official projections contained in SEC filings. As companies increasingly issued projections, private class action litigants routinely sued companies experiencing a

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88. Dawn A. Matsumoto, *Management's Incentives to Avoid Negative Earnings Surprises*, 77 ACCT. REV. 483, 488 (2002).

89. *See* REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION D-14 (Nov. 3, 1977). It is worth noting that both Warren Buffett and Martin Lipton, who in the present day have proposed reform of the current system, were members of that committee. *See* Benoit, *supra* note 3; Dimon & Buffett, *supra* note 3.

90. *See, e.g.*, Joel Seligman, *The SEC's Unfinished Soft Information Revolution*, 63 FORDHAM L. REV. 1953, 1956 (1995) (noting argument that "by prohibiting disclosure of earnings projections, [the SEC] had perpetuated a form of differential disclosure").

91. *See* John C. Burton, *Forecasts: A Changing View From the Securities and Exchange Commission*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 14, at 81, 84–85 (noting that corporate budgeting was not as developed when SEC initially prohibited projections but since then "a whole generation of managers has grown accustomed to the use of a budget as a major tool of management control").

92. *See* Guides for Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5992, Exchange Act Release No. 15305 (Nov. 7, 1978) ("[E]ncourag[ing] companies to disclose management projections . . . whether or not included in Commission filings.").

93. Safe Harbor Rule for Projections, Securities Act Release No. 6084 (June 25, 1979) (adopting 17 C.F.R. §§ 230.175(c), 240.3b-6).

significant stock price decline after failing to meet a quarterly projection and argued that those projections did not have a reasonable basis.[94] One study reported that from January 1990 through December 1993, forty percent of securities litigation cases alleged that the defendant failed to meet a projection.[95] Companies thus claimed that there was too much risk for them to publicly issue projections.[96]

Such private litigation undermined the SEC's policy of encouraging companies to disclose projections and created the perception that securities class actions taxed innovation. Though it often has viewed private securities litigation as supplementing its mission of investor protection, the SEC supported the passage of federal legislation to limit litigation challenging the failure to meet a projection. Partly because of the SEC's support, in 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA),[97] which contained a broad safe harbor that applied not only to projections in SEC filings, but to projections issued through less formal avenues such as a speech or press release.[98] It raised the standard of liability significantly, requiring knowledge that the projection was false to be liable under Rule 10b-5. Even when a projection is knowingly false, if it is paired with meaningful cautionary language, the projection will not be the basis for Rule 10b-5 liability.[99]

C. The Modern Quarterly Reporting System

By the late 1990s, the quarterly reporting system undeniably had a significant influence on the behavior of public companies. In a famous 1998 speech, SEC Chairman Arthur Levitt highlighted the existence of what he called a *Numbers Game*, where companies would misstate their earnings by small amounts to meet their earnings projections.[100] In doing so, they were attempting to avoid a negative market reaction for missing a forecast. By this point, quarterly projections had generated enough pressure so that many companies felt compelled to cheat to create the appearance of meeting them.

The SEC understandably viewed this problem through the lens of investor protection. The issue to it was that companies were misleading investors by creating the appearance that they were meeting projections. The simple solution was to make disclosure more accurate. The SEC did not seriously consider the possibility that

94. Safe Harbor for Forward-Looking Statements, Securities Act Release No. 7101, 57 SEC Docket 1999, at 16 (Oct. 13, 1994).

95. *See* James D. Beck & Sanjai Bhagat, *Shareholder Litigation: Share Price Movements, News Releases, and Settlement Amounts*, 18 MANAGERIAL & DECISION ECON. 563 (1997).

96. J. Carter Bebse, Jr., *Now It's SEC vs. the Lawyers*, WALL ST. J., Oct. 28, 1994, at A16.

97. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. § 78u-4 (2010)).

98. *See* 15 U.S.C. §§ 77z-2, 78u-5 (2012).

99. There is evidence that more companies began issuing forward-looking statements after the passage of the safe harbor. *See* Marilyn F. Johnson, et al., *The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms*, 39 J. ACCT. RES. 297 (2001).

100. Arthur Levitt, Chairman, SEC, Remarks at NYU Center for Law and Business: The "Numbers Game" (Sept. 28, 1998) (transcript available at https://www.sec.gov/news/speech/speecharchive/1998/spch220.txt [https://perma.cc/C9YW-VNDN]).

the need to meet quarterly forecasts was a problematic source of pressure on public companies.

As a result, the SEC doubled down on the quarterly reporting system. It took the position that companies must be extremely precise in reporting quarterly results to investors. For years before, auditors operated under the assumption that some accounting issues had only a small impact on a company's results and should not be important to investors.[101] They applied a bright-line rule where an earnings error would not be material to investors if it affected less than five percent of the company's earnings.[102] Some companies abused this rule to justify accounting decisions that were objectively wrong to meet their quarterly projections.[103] Soon after Levitt's *Numbers Game* speech, the SEC began requiring auditors to apply a vague, multi-factor test in assessing the materiality of a potential misstatement. Even a small error can be material if it "hides a failure to meet analysts' consensus expectations" or was motivated to "'manage' reported earnings."[104]

In addition to addressing the accuracy of quarterly reports, the SEC attempted to reform the process by which companies disseminated information about whether they would meet market expectations. Selective disclosure not only allowed analysts to develop accurate forecasts, it permitted favored investors to learn whether a company would meet or miss a projection. The SEC attempted to level the playing field through Regulation FD,[105] which requires full disclosure of material information a company conveys to analysts. In doing so, the SEC made it more difficult for companies to shape quarterly projections through backdoor channels.

Quarterly disclosure became even more burdensome after the spectacular collapse of Enron and WorldCom. Both companies committed accounting fraud to meet quarterly projections. Like the SEC, Congress viewed this as an investor protection issue that could be addressed by improving the accuracy of public company internal controls. The resulting statute, Sarbanes-Oxley, requires public companies to devote significant resources to ensure the integrity of their periodic reports.

Viewed solely through the lens of investor protection, efforts to increase the accuracy of quarterly disclosure are desirable. However, when the issue is broadened to consider the issue of short-termism, these efforts arguably reinforce what might be a flawed system. Modern SEC policy has mainly focused on issues relating to

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101. *See* Paul S. Atkins, Comm'r, SEC, Remarks Before the American Institute of Certified Public Accountants (Dec. 5, 2005) (transcript available at https://www.sec.gov/news/speech/spch120505psa.htm [https://perma.cc/B85N-MLDV]) (criticizing SAB-99).

102. SEC Staff Accounting Bulletin No. 99, 17 CFR Part 211 (Aug. 1999) (describing a "rule of thumb" where "the misstatement or omission of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances . . . .").

103. *See* James J. Park, *Assessing the Materiality of Financial Misstatements*, 34 J. CORP. L. 513, 524–26 (2009).

104. SEC Staff Accounting Bulletin No. 99, *supra* note 102.

105. 17 C.F.R. § 243 (2019).

disclosure regulation without extensively considering the possibility that quarterly projections should be regulated.

II. THE QUARTERLY REPORTING SYSTEM AND SHORT-TERMISM

The emergence of the modern quarterly reporting system in the 1970s coincided with a broader shift in theories of corporate purpose.[106] The understanding that managers could consider the interests of corporate stakeholders gave way to shareholder primacy, where managers are expected to maximize shareholder wealth. As disclosure became more uniform and reliable, and projections became the accepted way of judging company performance, public companies were increasingly expected to deliver short-term results. Other developments such as changes in executive compensation packages and the rise of activist investors have also affected managerial incentives, but the quarterly reporting system has been especially influential because it fundamentally requires public companies to manage their short-term performance. Moreover, the quarterly reporting system has influenced investors, many of whom base their trading strategies on predicting whether a company meets its quarterly projections. While the quarterly reporting system is not the only cause of short-termism, and its precise impact on corporate behavior is unclear, it is an important contributor.

A. Corporations

Compared to the scrutiny of hedge fund activism, the quarterly reporting system does not create intense pressure on corporations to take drastic measures. While it is not as powerful as a proxy battle, quarterly reporting covers a much broader range of public companies than the few that are subject to a major shareholder campaign.[107] While the evidence is unclear with respect to whether the frequency of disclosure significantly contributes to short-termism, there is a case that the pressure of meeting projections can result in a short-term emphasis by corporations that in certain circumstances results in the destruction of long-term value.

1. Quarterly Disclosure

When companies are required to disclose more frequently, they must take care to generate strong results for more periods than when they disclose less frequently.

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106. *See, e.g.*, LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 18–19 (2012) (tracing origins of shareholder primacy to the 1970s).

107. A recent report found that from 2014 to 2018, an average of 272 companies each year were subject to a public activist campaign. Only 56 of these interventions involved a proxy context. *See* SULLIVAN & CROMWELL, REVIEW AND ANALYSIS OF 2018 SHAREHOLDER ACTIVISM 26 (2019), https://www.sullcrom.com/files/upload/SC-Publication-SandC-MnA-2018-US-Shareholder-Activism-Analysis.pdf [https://perma.cc/D8EH-2WSE]. Moreover, not all such campaigns request corporate action to boost short-term returns. *See id.* at 27.

With annual disclosure, a company need only show once a year that its earnings have grown, or at least remained stable, relative to the prior period. With quarterly disclosure, markets will make such a determination four times a year.

Managers will thus have an incentive to make decisions that will show that their performance is improving for each quarter. Their strategy will differ relative to when they only need to show improvement on a yearly or semiannual basis. Some economists have thus theorized that more frequent disclosure creates an incentive to choose projects that generate results immediately rather than over time.[108] If such projects create less value than the ones that would have been chosen if the company was subject to less frequent disclosure, a quarterly disclosure mandate could reduce firm value.[109]

But quarterly disclosure requirements will only substantially affect firm decision-making if markets find it difficult to assess the value of firm projects. In an efficient market, a company's stock price should not be seriously affected by short-term fluctuations in company performance.[110] When markets are unable to adequately evaluate a project, managers can persuade investors of the project's worth by sending credible signals that it is succeeding.[111] As businesses have grown larger and more complex, it has become especially difficult for investors to assess them.[112] Investors, like all individuals, find it useful to rely on simple heuristics to simplify complexity.[113]

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108. Frank Gigler et al., *How Frequent Financial Reporting Can Cause Managerial Short-Termism: An Analysis of the Costs and Benefits of Increasing Reporting Frequency*, 52 J. ACCT. RES. 357 (2014) (noting that more frequent disclosure increases the risk of short-termism but also deters investment in value-destroying projects).

109. Moreover, quarterly disclosure can be a tax on management time. *See, e.g.*, Lawrence H. Summers & Victoria P. Summers, *When Financial Markets Work Too Well: A Cautious Case For a Securities Transactions Tax*, 3 J. FIN. SERV. RES. 163, 173 (1989) ("It is not uncommon for the chief executive officers of major U.S. corporations to spend a week or more each quarter telling their corporate story to security analysts."). However, such efforts will also create benefits for both issuers and investors.

110. *See, e.g.*, Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 336–39 (1990) (arguing that efficient markets do not cause myopia by managers); Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655, 655 (1989) (noting efficient markets argument that "since it is unlikely that the market can be systematically fooled by inflated earnings, managers will only lower stock prices by undertaking actions that are not in the best long-run interests of their companies").

111. *See, e.g.*, Stein, *supra* note 110, at 657; *see also* M.P. Narayanan, *Managerial Incentives for Short-Term Results*, 40 J. FIN. 1469 (1985) (showing that managers have incentive to boost short-term results because their competence is difficult to assess).

112. *See, e.g.*, MARGARET M. BLAIR & STEVEN M. H. WALLMAN, UNSEEN WEALTH: REPORT OF THE BROOKINGS TASK FORCE ON INTANGIBLES 25–28 (2001) (describing difficulty of valuing intangible assets); George S. Georgiev, *Too Big to Disclose: Firm Size and Materiality Blindspots in Securities Regulation*, 64 UCLA L. REV. 602 (2017) (observing that materiality standard permits large firms to limit disclosure); Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329 (2003) (noting inability of markets to adequately analyze and interpret information concerning Enron).

113. *See, e.g.*, Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCI. 1124, 1124 (1974) (observing that "people rely on a limited number of heuristic

The ability of corporate managers to continually improve performance on a quarterly basis provides assurance to investors that a project is creating value. There is significant evidence that markets prefer smooth rather than choppy earnings.[114] As market valuations are increasingly based on speculative projections of future performance, the ability of management to continually deliver quarterly results provides assurance that such performance will continue. While managers could demonstrate such competence on a yearly basis, strong quarterly results can provide investors with additional confidence that a high market capitalization is warranted. Companies may fear that if they do not deliver smooth earnings, they will be unfairly punished by the market and face an intervention from an activist investor.[115]

Even if the quarterly reporting system creates an incentive to manage to the short-term, the question is whether short-termism significantly impacts many firms.[116] Indeed, some public companies are essentially unaffected by the quarterly reporting system. A company may be so successful that it easily delivers quarter after quarter of consistent earnings growth.[117] Other companies combine a compelling long-term strategy with market dominance that convinces investors that a lofty valuation is justified even without immediate profitability. The ability to opt out of the quarterly reporting treadmill is not limited to dominant companies. Less successful companies that are not followed by research analysts have little incentive to manage quarterly results.

There is some empirical evidence on the question of whether the frequency of reporting results in questionable short-term decisions such as lowering firm investment.[118] A study by Professors Kraft, Vashishtha, and Venkatachalam found a decrease in fixed asset investments of between 1.5 to 1.9 percent by companies that were required to increase the frequency of their disclosure from 1950 to

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principles which reduce the complex tasks of assessing probabilities and predicting values to simpler judgmental operations"). For example, investors continue to rely on credit ratings despite their many flaws. *See, e.g.*, Frank Partnoy, *What's (Still) Wrong with Credit Ratings?*, 92 WASH. L. REV. 1407, 1424 (2017) (noting continued "mechanistic reliance" on credit ratings).

114. *See, e.g.*, Degeorge et al., *supra* note 86, at 6–7 (finding that earnings thresholds are psychologically important to investors); Alfred Rappaport, *The Economics of Short-Term Performance Obsession*, 61 FIN. ANALYSTS J. 65, 65 (2005) ("Sizable stock price responses to earnings surprises suggest that short-term earnings, not long-term cash flow prospects, fuel price changes.").

115. *See, e.g.*, Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70 N.C. L. REV. 137, 142 (1991) (noting that "[t]he obsession many managers currently have with near-term earnings results partly from a perceived vulnerability to takeover resulting from the tendency of financial markets to 'discount' stocks"); Schwartz, *supra* note 7 (arguing that hedge funds use disclosure to pressure companies).

116. Even those skeptical of the impact of short-termism acknowledge that it likely affects some firms. *See, e.g.*, Roe, *supra* note 11, at 100.

117. Even companies that are consistently profitable can be pressured by projections if they do not deliver an increase as great as predicted.

118. There is also evidence that simply going public subjects companies to pressure that reduces investment relative to private companies. *See* John Asker et al., *Corporate Investment and Stock Market Listing: A Puzzle?*, 28 REV. FIN. STUD. 342 (2015).

1970.[119] They compared firms that were newly subject to requirements to increase disclosure with firms whose reporting requirements remained constant. One important limitation of the study is that because of a lack of data during this period it did not measure whether R&D spending declined. Another question is whether markets during this period were comparable to markets today. The cost of trading was higher prior to 1975, meaning that markets would have been less efficient in responding to obvious and significant cuts in investment.

Two studies examined the experience of the European Union, which mandated limited quarterly disclosure in 2004 only to repeal the mandate in 2013.[120] A paper by Professors Pozen, Nallareddy, and Rajgopal found no significant change in investment by companies in the UK that were forced to issue quarterly disclosure after the EU mandate relative to UK companies that had voluntarily disclosed on a quarterly basis before the EU mandate.[121] However, because the UK did not require that financial results be included in company quarterly disclosure,[122] the policy did not create uniform incentives to demonstrate improved financial performance.[123]

The second study, by Professors Ernstberger, Link, Stich, and Vogler, found an increase in real asset management by EU firms newly subject to a mandate of quarterly disclosure relative to firms that had been subject to a disclosure requirement before the EU mandate.[124] They defined real asset management in terms of overproduction and reduction of discretionary expenses. However, they did not look at whether company investment levels declined.[125] Moreover, the authors conceded that the "effects [they found] are considerably less pronounced that the effects documented [by other studies] for other events."[126]

While there is a theoretical case that more frequent periodic disclosure affects manager incentives, the empirical evidence does not definitively establish that

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119. *See* Arthur G. Kraft et al., *Frequent Financial Reporting and Managerial Myopia*, 93 ACCT. REV. 249, 260–61 (2018).

120. Currently, the EU only requires semiannual reporting. *See* Council Directive 2013/50, 2013 O.J. (L 294) 13 (EC). On the other hand, unlike the U.S., the EU also mandates continuous disclosure, requiring the immediate release of material information to investors. Council Regulation 596/2014, art. 17(1), 2014 O.J. (L 173) 34. It is thus not entirely clear whether the EU experience with quarterly disclosure would be informative with respect to U.S. quarterly disclosure.

121. *See* Robert Pozen et al., *Impact of Reporting Frequency on UK Public Companies*, CFA INSTIT. RES. FOUND. BRIEFS 6 (2017).

122. Moreover, there is less pressure from research analysts in the UK than in the U.S. *See, e.g.*, KAY, *supra* note 13, at 64 (observing that the "dysfunctional process of earnings management and earnings guidance has not yet reached the scale achieved in the US").

123. After this quarterly mandate was lifted, a majority of companies continued voluntarily issuing quarterly disclosures. *See* Owen Walker, *The Long and Short of the Quarterly Reports Controversy*, FIN. TIMES (July 1, 2018), https://www.ft.com/content/e61046bc-7a2e-11e8-8e67-1e1a0846c475 [https://perma.cc/8KJ3-G8VF].

124. *See* Jurgen Ernstberger et al., *The Real Effects of Mandatory Quarterly Reporting*, 92 ACCT. REV. 33, 51–54 (2017).

125. *See, e.g.*, Kraft et al., *supra* note 119, at 251.

126. Ernstberger et al., *supra* note 124, at 56.

increasing the frequency of disclosure significantly impacts firm behavior.[127] Because changes in disclosure requirements occur infrequently, it is difficult to test the hypothesis that increasing the number of periodic filings significantly increases short-termism.

2. *Quarterly Projections*

At the very least, quarterly projections amplify the tendency of quarterly disclosure to incentivize short-termism. While managers would have an incentive to increase earnings even if they did not need to meet analyst forecasts, a projection puts a precise number on what the market is expecting. Such precision reflects extensive models of future earnings that become unraveled when the failure to meet a quarterly projection requires rethinking a stream of predicted earnings.

There is also a case that projections are the primary driver of short-termism. Even if the frequency of quarterly disclosure was reduced, if a semiannual or annual report is evaluated in relation to a projection, there will be pressure to meet that projection.

There is substantial evidence that projections affect managerial decision-making. An often-cited survey of Chief Financial Officers in 2005 found that "80% of survey participants report that they would decrease discretionary spending on R&D, advertising, and maintenance to meet an earnings target."[128] Moreover, "[m]ore than half (55.3%) state that they would delay starting a new project to meet an earnings target, even if such a delay entailed a small sacrifice in value."[129] Because "[p]redictability of earnings is an over-arching concern among CFOs . . . 78% of the surveyed executives would give up economic value in exchange for smooth earnings."[130]

Even if many public companies make questionable decisions to meet projections, the question is whether the manipulations are significant. The 2005 study does not document the size of the hypothetical manipulations and only established a willingness to delay a project for a "small sacrifice in value." Markets

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127. Even if there is a link between quarterly disclosure and reduced investment, there are other causes for such trends that may be more significant. *See, e.g.*, Robert C. Pozen & Mark Roe, *Keep Quarterly Reporting*, CFO.COM (Aug. 27, 2018), http://ww2.cfo.com/regulation/2018/08/keep-quarterly-reporting/ [https://perma.cc/7V2L-VV9X] ("[I]t's a mistake to blame quarterly stock market reporting for reduced capital spending. Something else is operative—factors such as the movement to capital-light, technology-oriented economies; the rise of Asian manufacturing; and the weakness, until recently, of the economy overall.").

128. John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3, 32–35 (2005).

129. *Id.* at 5. Another concern is that the importance of meeting quarterly projections makes it difficult for managers to consider the interests of stakeholders. Meeting quarterly projections can be facilitated by cutting resources that might benefit workers or reduce the environmental impact of a corporation's policies.

130. *Id.*; *see also* Sugata Roychowdhury, *Earnings Manipulation Through Real Activities Manipulation*, 42 J. ACCT. & ECON. 335, 336 (2006) (finding evidence that managers manipulate financial results to avoid annual losses).

would react to a decision that obviously compromises long-term value. For example, if a company made a large and obvious cut in R&D expenditures to meet quarterly projections, its stock price should decline as the market realizes that it has sacrificed its long-term growth.[131] Even when manipulations are not as obvious, it is difficult to indefinitely hide decisions that significantly reduce firm value. One study shows that over time, companies that meet projections with low quality earnings will underperform the market.[132]

Projections are most likely to induce inefficient behavior if they are unrealistically high. Professor Michael Jensen argues that irrationally high equity valuations create agency costs as managers strive to meet impossible expectations.[133] In doing so, they may engage in reckless behavior that destroys confidence in the company if discovered. Initially manipulations to meet an unrealistic projection may be small and motivated by genuine optimism that future performance will improve.[134] However, every manipulation makes it more difficult to meet projections in the future.[135] Managers may then commit fraud to delay revealing earlier manipulations. If the earnings shortfall becomes too large to hide and comes to light, the company's stock price will collapse. Starting towards the end of the 1990s, many of the most notorious securities frauds such as Enron and WorldCom were driven by the desire to convey the impression that a company was consistently meeting its quarterly projections.[136]

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131. On the other hand, there is evidence that short-term pressure can result in reduced R&D expenditures. *See, e.g.*, John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 574–77 (2016) (summarizing studies).

132. *See, e.g.*, Sanjeev Bhojraj et al., *Making Sense of Cents: An Examination of Firms That Marginally Miss or Beat Analyst Forecasts*, 64 J. FIN. 2361, 2363–64 (2009) (finding for period from 1988 to 2006 that firms that meet projections with low quality earnings underperform the market over the long-run).

133. Michael C. Jensen, *Agency Costs of Overvalued Equity*, 34 FIN. MGMT. 5, 8–10 (2005) (describing pressures of high equity valuations on management).

134. *See, e.g.*, DONALD C. LANGEVOORT, SELLING HOPE, SELLING RISK: CORPORATIONS, WALL STREET, AND THE DILEMMAS OF INVESTOR PROTECTION 35–37 (2016) (describing "slippery slope fraud"); Baruch Lev, *Corporate Earnings: Facts and Fiction*, 17 J. ECON. PERSP. 27, 36 (2003) (observing that "the more common reason for earnings manipulation is that managers, forever the optimists, are trying to 'weather out the storm'—that is, to continue operations with adequate funding and customer/supplier support until better times come").

135. In addition to creating an incentive for fraud, the pressure to meet expectations can cause inefficient behavior. *See, e.g.*, Jensen, *supra* note 133, at 10 ("To appear to be satisfying growth expectations you use your overvalued equity to make long run value destroying acquisitions; you use your access to cheap debt and equity capital to engage in excessive internal spending and risky negative net present value investments that the market thinks will generate value . . . .").

136. Second Amended Complaint ¶ 15, Sec. & Exch. Comm'n v. Lay, Civ. No. H-04-0284 (S.D. Tex. July 8, 2004), https://www.sec.gov/litigation/complaints/comp18776.pdf [https://perma.cc/74GE-U63H] (noting that motivation of fraud was to "meet or exceed the published expectations of industry analysts forecasting Enron's reported earnings-per-share and other results"); First Amended Complaint ¶ 3, Sec. & Exch. Comm'n v. WorldCom, Inc., Civ. No. 02-CV-4963 (S.D.N.Y. Nov. 5, 2002), https://www.sec.gov/litigation/complaints/comp17829.htm [https://perma.cc/3Y3X-LQ8X] (alleging that "WorldCom's fraudulent accounting practices . . . were designed to and did falsely and fraudulently inflate its income to correspond with

However, it is unclear whether companies frequently face unrealistic projections. Managers are not helpless in the face of market judgments. Companies can manage expectations so that they are more realistic. Some do so actively and openly, issuing their own projections and guidance to analysts to avoid surprise earnings shortfalls.[137] Others do so more quietly, discreetly leaking information in private meetings with analysts who incorporate such information into their reports and forecasts. Managers can moderate expectations so that they can be met or exceeded.[138]

Some companies, though, do not wish to correct unrealistic projections, or do not have the good judgment to do so. They may fuel optimism that results in an unrealistically high value for their stock because they are influenced by their corporate culture or have individual incentive to boost the company's stock price.[139] Past success can result in a treadmill where it becomes more difficult to meet increasing market expectations.[140] Managers may fear the consequences of issuing more realistic earnings forecasts.

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estimates by Wall Street analysts and to support the price of WorldCom's common stock in the market."); Complaint ¶ 2, Sec. & Exch. Comm'n v. Xerox Corp., Civ. No. 02-272789 (DLC) (S.D.N.Y. Apr. 11, 2002), https://www.sec.gov/litigation/complaints/complr17465.htm [https://perma.cc/FU8J-N32W] (noting that accounting fraud "allowed Xerox to meet or exceed Wall Street expectations in virtually every reporting period from 1997 through 1999").

137. Studies during the mid-1990s found that only a minority of companies voluntarily issued information to preempt a significant earnings miss. *See, e.g.*, Ron Kasznik & Baruch Lev, *To Warn or Not to Warn: Management Disclosures in the Face of an Earnings Surprise*, 70 ACCT. REV. 113, 114 (1995); Douglas J. Skinner, *Why Firms Voluntarily Disclose Bad News*, 32 J. ACCT. RES. 38, 40 (1994). A study by the consulting firm McKinsey found no economic benefit for companies that provide their own guidance to the market. *See* Peggy Hsieh et al., *The Misguided Practice of Earnings Guidance*, 19 MCKINSEY ON FIN. 1, 1 (2006).

138. There is evidence that companies with results exceeding market projections can earn abnormal positive returns. *See, e.g.*, Eli Bartov et al., *The Rewards to Meeting or Beating Earnings Expectations*, 33 J. ACCT. & ECON. 173, 175 (2002). During the late 1990s, the journalist Michael Lewis reported that "Wall Street analysts have low-balled their earnings estimates so that their corporate customers could announce to the press that they had 'beaten' those estimates." Michael Lewis, *In Defense of the Boom*, N.Y. TIMES MAG., Oct. 27, 2002, at 44. More recently, even with the passage of Regulation FD, companies privately urge analysts to lower their estimates. *See* Thomas Gryta et al., *Analysts Steered to "Surprises"—Companies' Nudges and Phone Calls Lead to Lower Estimates That Are Easier to Beat*, WALL ST. J., Aug. 5, 2016, at A1.

139. *See, e.g.*, Joseph Fuller & Michael C. Jensen, *Just Say No to Wall Street: Putting a Stop to the Earnings Game*, 14 J. APPLIED CORP. FIN. 41, 42 (2002) ("As stock options became an increasing part of executive compensation, and managers who made great fortunes on options became the stuff of legends . . . management teams proved reluctant to undermine their own stature by surrendering hard-won records of quarter-over-quarter earnings growth."); Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 108 (1997) ("[C]orporate cultural biases, particularly optimistic ones, can be adaptive mechanisms for encouraging trust and cooperation, and for deflecting the selfishness-inducing-last-period problem that arises in times of stress and threat.").

140. *See, e.g.*, TIM KOLLER ET AL., VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES 51–52 (6th ed. 2015) (describing expectations treadmill).

There is a case that the quarterly reporting system creates incentives for managers to generate short-term results. However, the extent and impact of any effect is difficult to measure. It is unclear that the frequency of disclosure is a significant factor. There is a stronger argument that pressure from unrealistic earnings projections can result in the significant destruction of long-term value.

B. Investors

The quarterly reporting system not only affects the behavior of corporations, it influences the strategies of investors. Rather than working to assess the fundamental value of a stock, short-term traders have an incentive to focus on predicting whether a company will meet its earnings projections for the quarter.[141] With more frequent earnings releases, there are more opportunities to trade on earnings. Such trading amplifies the market reaction to such results, making them more significant and increasing the incentive for public companies to manage their short-term results.

Scholars who study stock markets often distinguish between noise traders and information traders.[142] A noise trader buys and sells stock without considering information that relates to its fundamental value. He might buy a stock because he sees patterns in the price movements suggesting that the price will rise, or simply by guessing. An information trader buys and sells stock based on his assessment of information relating to the corporation that has issued the stock. Information traders may execute a value strategy, where they seek to identify when the market price of the stock does not reflect its true value.

Quarterly results will draw the attention of both types of traders. A noise trader may sell when a corporation misses its earnings projection, not because he believes the company is worth less as a result, but because he anticipates that other traders will sell. An information trader will invest time in gathering information to predict whether the company is likely or unlikely to meet its projections. Perhaps he might make visits to stores towards the end of a quarter to see if there are long lines. The release of quarterly results will provide verification about whether the information trader's assessment is correct.

In addition to legitimate efforts to predict quarterly results, some investors will attempt to simply obtain the answer in advance. The Second Circuit's 2014 decision in *United States v. Newman* described a culture where companies leaked advance copies of quarterly reports to hedge funds.[143] Research "analysts routinely solicited information from companies in order to check assumptions in their models in

141. *See, e.g.*, Rappaport, *supra* note 114 ("[F]inancial analysts fixate on quarterly earnings at the expense of fundamental research.").

142. *See, e.g.*, Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 714–15 (2006).

143. United States v. Newman, 773 F.3d 438, 454 (2d Cir. 2014) ("[I]nvestor relations personnel routinely 'leaked' earnings data in advance of quarterly earnings.").

advance of earnings announcements."[144] These practices were seen as so common by the Second Circuit that it found that a reasonable investor would not believe that such information was disclosed improperly.[145]

There is an argument that speculative trading on short-term results is essentially rent-seeking of little social value.[146] Noise trading only shifts gains and losses between traders who are making little effort to assess the stock's true value. Insider trading on periodic results undermines the integrity of mandatory disclosure by generating private gains for those who have access to information that will already be conveyed to the public.[147]

The strongest argument that trading around quarterly results has value is with respect to information traders. By gathering information to predict short-term performance, such traders may gain insights into the long-term performance of a company. The question, though, is whether the effort of predicting quarterly results generates meaningful information about a public company's long-term prospects. Assessing whether a corporation is meeting projections is arguably no more than a heuristic for those investors who cannot meaningfully determine the corporation's value.[148]

In a world with less frequent periodic disclosure, there would be fewer significant events around which trading would occur. If such trading is purely rent-seeking, society overall would benefit from reducing it. On the other hand, if trading on periodic disclosure conveys valuable information to the market, eliminating quarterly disclosure would lessen the incentive to gather information on a company throughout the year.

Perhaps the increasing shift to diversified investments suggests that short-termism is not pervasive in today's stock markets. Many investors have defaulted to a passive strategy, where they buy and hold a broad portfolio for many years. Their hope is that over time, such a strategy will outperform one that requires analysis of the financial prospects of particular companies. Investors with long-term horizons have less of an interest in quarterly disclosure. If passivity is increasing

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144. *Id.*

145. Markets are said to develop "whisper numbers" that reflect a more accurate assessment of the company's results than public projections. *See, e.g.*, ECCLES ET AL., *supra* note 3, at 83–89.

146. *See, e.g.*, Joseph E. Stiglitz, *Using Tax Policy to Curb Speculative Short-Term Trading*, 3 J. FIN. SERVICES RES. 101, 102–03 (1989) (describing argument that speculative trading is essentially rent-seeking); Merritt B. Fox et al., *Informed Trading and Its Regulation*, 43 J. CORP. L. 817, 853 (2018) (concluding that short-term trading is unlikely to improve allocative efficiency).

147. James J. Park, *Insider Trading and the Integrity of Mandatory Disclosure*, 2018 WIS. L. REV. 1133, 1165.

148. *See, e.g.*, Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 985 (2013) ("Because they cannot evaluate complex, long-term, technologically sophisticated information well, they rely on simple signals to evaluate the value of the corporate stock in their portfolio. Quarterly earnings results accordingly loom larger than they would otherwise, because of their relative simplicity."); *see also* Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803 (2008) (describing problems with relying on heuristics relating to governance).

despite the influence of the quarterly reporting system, it suggests that such reporting has not been decisive in affecting the time-horizons of investors. As experience shows that the gains from trading on quarterly results are elusive, investors will be less likely to pursue such trading strategies.

The criticism of the quarterly reporting system might be linked to the increasing clout of long-term shareholders.[149] Such investors are not as concerned about short-term fluctuations[150] and might be worried that short-term trading strategies are distorting the incentives of corporations.[151] They might prefer a market where managers have more leeway to execute strategies that increase value over time. On the other hand, it is far from clear that it would be in the best interest of long-term shareholders to promote policies that could shield managers from market scrutiny. The question for long-term shareholders is whether they benefit from the information gathering of traders who seek to predict earnings on a quarterly basis.

In addition to affecting the behavior of managers, the quarterly reporting system influences investors. The quarterly reporting system creates rent-seeking by investors that amplifies corporate short-termism.

III. QUARTERLY REPORTING SYSTEM REFORMS

This Part evaluates potential reforms to the quarterly reporting system that could address the problem of short-termism.[152] Because quarterly disclosure is not the only cause of short-termism, the SEC should consider addressing other contributors such as reliability requirements and projections. This Part concludes that modest reforms such as increasing disclosure relating to projections are more promising than radical reforms such as reducing the frequency of periodic disclosure.

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149. *See, e.g.*, Coffee & Palia, *supra* note 131, at 581 (noting conflict between diversified investors and hedge funds).

150. *See, e.g.*, Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 580 (2006) (noting that "longer-term investors" are "less concerned with quarterly or annual performance").

151. *See, e.g.*, THE ASPEN INST., OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT 2 (2009) ("[T]he focus of some short-term investors on quarterly earnings and other short-term metrics can harm the interests of shareholders seeking long-term growth and sustainable earnings, if managers and boards pursue strategies simply to satisfy those short-term investors.") [hereinafter THE ASPEN INST., OVERCOMING SHORT-TERMISM].

152. It does not consider reforms such as taxing securities transactions or reforming executive compensation that fall outside the core of securities disclosure regulation. It also does not address potential reforms to the timing of disclosure by investors of significant stakes in a public company, which have been addressed extensively elsewhere. *See, e.g.*, Leo E. Strine, *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870, 1958–64 (2017).

A. Changing the Frequency of Periodic Disclosure

If the frequency of periodic disclosure is a significant cause of short-termism, requiring fewer reports might give public companies additional room to look beyond the immediate future. The effect of such a policy change is difficult to predict. Reducing the number of periodic filings could result in a new order where public companies are not as subject to arbitrary judgments relating to quarterly results. Or, it may not substantially change the pressure on managers to demonstrate earnings growth.

Rather than require less disclosure, another possible way of addressing short-termism would be to require public companies to increase their disclosure. Continuous disclosure would reduce the market's focus on arbitrary quarterly benchmarks. The question is whether such continuous reporting would be cost-effective and useful to investors.

Given the weak evidence that the frequency of periodic disclosure is the primary cause of short-termism, radical change to the mandate of quarterly disclosure is unwarranted at this time.

1. Reducing Periodic Disclosure

While it was initially dismissed as an unrealistic option for larger public companies, the SEC has taken the proposal for a semiannual or annual disclosure system seriously.[153] Predicting the effects of such a policy requires a significant amount of speculation. Understanding the relationship between quarterly disclosure and quarterly projections provides an additional lens through which to assess the proposal.

a. The Optimistic Scenario

Under an optimistic scenario, reducing mandatory periodic disclosure would permit public companies to negotiate their own disclosure agreements with markets. Investors would likely permit some companies to disclose less frequently. Those companies would save on the costs of disclosure and be freed from demonstrating that their business is improving on a quarterly basis. For such companies, investors might focus less on their periodic financial results and would instead use other measures to assess their performance.

The possibility that issuers would benefit from the ability to choose tailored disclosure rules has been analyzed in articles by Professor Romano and Professors Choi and Guzman.[154] If issuers have more flexibility to choose their disclosure

153. *See supra* note 5.

154. *See, e.g.*, Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998). *But see* Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) (questioning benefits of reducing mandatory disclosure).

regime, they will choose the regime that optimizes their value. Companies that are content to grow slowly but steadily through implementation of a long-term strategy could opt out of quarterly disclosure. Companies that seek to grow quickly through a risky project that is difficult to monitor might prefer to issue quarterly reports that give markets comfort about the progress of the project.

Even if issuers are not required to file quarterly disclosure, they will have the incentive to voluntarily release public updates when there are significant developments. Companies already issue interim reports even when they are not required to, and they would not stop the practice simply because they are subject to less mandatory disclosure. Rather than win the trust of markets by consistently delivering quarterly results, public corporations would establish their credibility by diligently keeping investors informed about important developments.

b. The Pessimistic Scenario

Under a pessimistic scenario, eliminating quarterly disclosure would lessen transparency without materially addressing the problem of short-termism. Reducing mandatory disclosure might not eliminate pressure from investors to demonstrate financial performance and simply re-direct it to other avenues.

Even if public companies were not subject to a quarterly disclosure mandate, they would be subject to projections. Analysts would still issue forecasts of semiannual and annual results. Companies would still feel compelled to meet such projections. Such tests would be even more consequential if they only occur once or twice a year rather than every quarter.

A danger of reducing quarterly disclosure is that investors will not be able to distinguish between those companies that do not need to report on a quarterly basis from those that should be. If investors cannot meaningfully make such distinctions, they might indiscriminately punish all companies that opt out of quarterly disclosure. As a result, most companies would feel compelled to continue such reporting.

Because less frequent periodic disclosure would not affect investor demand for information, such a policy change might not do much to reduce managerial work to generate disclosure for investors. Without a clear rule concerning when significant disclosure should be released, managers will have to make judgments about when markets need information. Investors would grade managers based on whether they make the correct decision about when the market needs additional disclosure. If markets are undervaluing or overvaluing the stock, should the company correct the misperception, or wait until its annual report? How will managers know if the stock is over or undervalued?

A discretionary disclosure system could reduce the transparency of the process by which information is conveyed to the market. Rather than correct misperceptions by publicly releasing quarterly results, companies might do so privately. The advantage of sophisticated investors who meet frequently with management would grow significantly. Companies could not provide precise

information without running afoul of Regulation FD,[155] but they might be willing to provide hints about their recent performance that would give investors with favored access an edge. The benefit of quarterly disclosure, that it essentially equalizes the playing field every three months, would be compromised with less frequent disclosure.[156]

Without quarterly disclosure, there would be pressure to increase mandatory disclosure in other ways. Because of mandatory quarterly reports, seasoned companies need not file an extensive registration statement when selling securities.[157] The SEC assumes that for such companies, markets are efficient and reflect the information contained in prior disclosures. That assumption would no longer hold if quarterly disclosure was not mandated, and there would be a case that public companies should disclose extensive information whenever they sell securities.

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On balance, while there are benefits to reducing the frequency of quarterly filings, there are significant risks. Because investors will continue to demand information, the burdens of reporting may not be significantly reduced. Given the lack of clear evidence that the frequency of disclosure in itself has a significant impact on public company decision-making, the case for radical change is weak.

2. *Continuous Disclosure*

If the problem with quarterly disclosure is that it results in an overemphasis on periodic results, perhaps the SEC should consider moving away from periodic disclosure. Rather than limiting disclosure to a quarterly, semiannual, or annual basis, the SEC could mandate continuous disclosure. If issuers were required to constantly release material information, markets would not place as much emphasis on quarterly or even annual reports. Managers would thus not feel compelled to alter their strategies to demonstrate performance for an arbitrary period.

But as I discussed in an earlier paper, there is good reason why mandatory disclosure is periodic rather than continuous.[158] If securities regulation reflects the results of a hypothetical bargain between investors and issuers, periodic disclosure

155. *See* 17 C.F.R. § 243.100 (2019) (requiring public disclosure of material information conveyed to specified parties).

156. An interesting proposal by Professors Haeberle and Henderson argues that a market for information where investors could pay for early access to company information would produce the optimal amount of disclosure. *See* Kevin S. Haeberle & M. Todd Henderson, *A New Market-Based Approach to Securities Law*, 85 U. CHI. L. REV. 1313, 1315–18 (2018). Such a system could supplement periodic disclosure on an annual basis and provide more transparency than the current system where such information is conveyed through informal interactions. A market for company disclosure would be challenging to implement because it would be difficult for investors to determine how much to pay for such information. *Id.* at 1372–74. Moreover, companies might prefer to influence markets more subtly rather than make open pricing decisions about the market value of their disclosure.

157. *See* Adoption of Integrated Disclosure System, 47 Fed. Reg. 11380 (Mar. 16, 1982).

158. Park, *supra* note 147, at 1153–55.

reflects the interests of those parties. Issuers will vigorously resist continuous disclosure because of its substantial costs.[159] Investors may not demand such disclosure because they prefer that managers contextualize results rather than release a stream of information that they may not understand.

Even if there is a case for continuous disclosure, it is unclear that the policy goal of reducing short-termism is compelling enough to substantially increase the costs of mandatory disclosure for public companies.

B. Reducing the Burdens of Quarterly Disclosure

At least some of the motivation for reforming quarterly disclosure is concern about the growing cost of preparing financial statements. Even if it did not change the frequency of disclosure, perhaps the SEC could reduce the burden of quarterly filings by relaxing reliability requirements.[160]

Securities regulation mandates that companies assess the accuracy of their quarterly disclosure. Unlike annual financial statements, quarterly financial statements do not need to be audited. However, as noted earlier, the 10-Q must conform to GAAP. Moreover, the company's auditor must review it[161] and has obligations to inquire into items that may not comply with GAAP.[162] Sarbanes-Oxley also requires the company's CEO and CFO to review the report and certify it does not have material misrepresentations and fairly presents the financial condition of the company.[163] An inaccurate 10-Q could trigger liability for securities fraud if a material misstatement was made with fraudulent intent.[164]

The most promising way of reducing the burden of the quarterly reporting system would be to narrow the definition of materiality for financial

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159. As noted earlier, the SEC has rejected continuous reporting because of its costs. *See supra* note 37.

160. A related proposal would maintain quarterly reports but only require abbreviated filings so that companies would only have to report select information such as a company's revenue with fuller reports on a semiannual basis. *See, e.g.*, Pozen & Roe, *supra* note 127 (proposing streamlining quarterly reports). Such a policy would result in some modest cost savings, but so long as companies were obligated to verify the accuracy of quarterly numbers, the cost of such reporting would still be significant.

161. 17 C.F.R. §§ 210.8–03, 210.10–01 (2019).

162. *See, e.g.*, *AS 4105.22*: *Reviews of Interim Financial Information*, PUB. COMPANY ACCT. OVERSIGHT BOARD (Dec. 15, 2017), https://pcaobus.org/Standards/Auditing/Pages/AS4105.aspx [https://perma.cc/RK7D-4RZQ].

163. *See* 17 C.F.R. §§ 240.13a–14, 240.15d–14 (2019). The lack of a certification requirement by individual officers initially distinguished 1934 reports from the registration statement, which long had required such signatures. *See* Cohen, *supra* note 35, at 1361.

164. *See, e.g.*, Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 318–19 (2007). Moreover, if a quarterly report is issued around the time the company sells securities, it is incorporated by reference into the company's registration statement. The registration statement is subject to a stringent liability standard where any material misstatement could trigger liability under Section 11 of the Securities Act of 1933, even if it is not made with fraudulent intent. *See* 15 U.S.C. § 77k(a) (2012).

misstatements.[165] As noted earlier, the qualitative approach to assessing the importance of a financial misstatement has been controversial. Even a very small error can be material enough to trigger liability if it permitted the company to meet an earnings projection.[166]

A simple reform would be for the SEC to de-emphasize the consideration of whether a misstatement allowed a company to meet a projection in determining whether the misstatement is material. For companies that just meet a projection, virtually any accounting error could be deemed material. Under this proposal, so long as it is not intentional, a small misstatement would not in itself be material, regardless of its effect on meeting market expectations. If quarterly disclosures were understood to be reasonable estimates rather than precise measurements, investors might focus less on whether quarterly results meet quarterly projections.[167] Quarterly reports could be viewed as uncertain rough drafts that are likely to be revised on an annual basis.

The danger of such a change is that it would give companies more leeway to manipulate financial statements to create the impression that they are consistently meeting quarterly benchmarks. Investors seeking updates generally assume that official SEC filings are reasonably accurate. The market's scrutiny of financial results predated the Sarbanes-Oxley reforms, and simply reverting to past practices would be unlikely to check short-termism. Experience has shown that companies will abuse their discretion to mislead investors. Reducing the verification of quarterly reports would undermine an aspect of the securities laws that seeks to check some of the dangers of short-termism.

The argument to reduce the costs of disclosure relates more to the issue of whether regulation has made public company status too burdensome than to the problem of short-termism. If verification costs are high, some companies may prefer to save those costs by remaining private. It is unclear, though, that the cost of quarterly disclosure by itself is decisive in that decision. The bulk of such costs would remain with respect to the company's annual or semiannual filings.

C. Qualitative Disclosure

If short-termism is a problem, perhaps disclosure regulation could encourage companies to better articulate their long-term plans to investors through qualitative disclosure. If such long-term disclosure was more effective, investors might place more importance on long-term strategies rather than short-term results. Relatedly, disclosure could be re-conceptualized so that it allows investors to assess factors

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165. *See* Park, *supra* note 103, at 550 (proposing that only persistent misstatements should be considered material).

166. *Id.* at 530–31.

167. The improved reliability of financial reports has been said to increase investor reliance on them. *See, e.g.*, Ken Brown, *Corporate Reform: The First Year: Wall Street Plays Numbers Game with Earnings, Despite Reforms*, WALL ST. J., July 22, 2003, at A1.

other than quarterly profits. Such social disclosure reforms have gained some support from investors and scholars.

1. Improving Long-term Disclosure

A few years ago, a prominent institutional investor argued that while public companies should continue to report on a quarterly basis, they should do more to articulate their long-term strategy to counteract the reliance on short-term projections.[168] The hope is that rather than reacting to a single number, investors will have information that allows them to put such results in a broader context.

Over the years, the SEC has attempted to make disclosure more qualitative so that it gives investors a richer picture of the company's strategy. For decades, the Management Discussion & Analysis (MD&A) section of SEC disclosure has had the goal of encouraging companies to provide more context to their financial results. This provision requires companies to "describe any 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."[169] The MD&A is "intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company."[170]

The question is whether companies convey unique and significant information about their long-term prospects in such qualitative disclosure. There is some evidence that the MD&A requirement increased the accuracy of stock prices, implying that markets find such narrative disclosures to be meaningful.[171] On the other hand, SEC disclosure has long been criticized because it is long-winded and does not clearly reveal useful information.[172] SEC filings are written by attorneys who tend to translate business information into language that is unlikely to trigger litigation. Moreover, the vagueness of the mandate to describe "trends or uncertainties" means that companies will differ with respect to the information that they provide. Indeed, the SEC has instructed that the "MD&A requirements are

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168. *See* Letter from Lawrence D. Fink, Chairman and Chief Exec. Officer, BlackRock, to S&P 500 Chief Executives (2016), https://www.blackrock.com/corporate/investor-relations/2016-larry-fink-ceo-letter [https://perma.cc/36XW-9KJY] ("[W]e do believe companies should still report quarterly results—'long-termism' should not be a substitute for transparency—but CEOs should be more focused in these reports on demonstrating progress against their strategic plans than a one-penny deviation from their EPS targets or analyst consensus estimates."); *see also* JACOBS, *supra* note 3, at 10 (arguing that "[l]ack of communication prevents investors from understanding management's long-term goals and objectives"); Steven A. Bank & George S. Georgiev, *Securities Disclosure As Soundbite: The Case of CEO Pay Ratios*, 60 B.C. L. REV. 1123, 1197–98 (2019) (proposing narrative discussion to replace pay ratio disclosure).

169. 17 C.F.R. § 229.303(a)(3)(ii) (2019).

170. Caterpillar Inc., Exchange Act Release No. 30532, 50 S.E.C. 903, 1992 WL 71907, at *6 (Mar. 31, 1992) [hereinafter Caterpillar Inc.].

171. *See, e.g.*, Fox et al., *supra* note 12, at 368–81; Volkan Muslu et al., *Forward-Looking MD&A Disclosures and the Information Environment*, 61 MGMT. SCI. 931, 945 (2015).

172. *See, e.g.*, Donald H. Meiers, *The MD&A Challenge*, 201 J. ACCT. 59 (2006).

intentionally flexible and general."[173] The SEC has brought cases against companies for inadequate MD&A disclosure,[174] but its enforcement has been sporadic, and it is difficult to derive clear rules from the cases that have been brought.

Even if companies provide useful MD&A statements, it is costlier for investors to assess such information than it is for them to compare a quarterly earnings disclosure with a projection. Long narrative discussions of long-term prospects are difficult to process and digest into investing strategies.[175] Comparison of qualitative disclosure issued by different companies is also difficult. The SEC has required MD&A since the early 1980s, and such disclosure did not prevent markets from shifting increasingly to analyst projections in assessing managerial competence towards the end of the 1980s. The relentless focus of markets on earnings projections despite SEC mandates to disclose qualitative information through the MD&A indicates that narrative disclosure will not divert markets from focusing on heuristics.

It is unlikely that shifting disclosure so that it encompasses more discussion about long-term plans by itself would change the short-term focus of periodic disclosure. So long as market movements are driven by projections, it is unlikely that improving the quality of long-term disclosure would check short-termism.

2. *Social Disclosure*

The securities laws have long mandated disclosure of information that is not directly related to a company's financial results. For example, companies are required to disclose information relating to executive compensation and certain environmental liabilities.[176] Professor Cynthia Williams defines such social disclosure expansively to "include general information about what products a company sells, in what countries it does business, its employment and environmental records (both domestic and global), and specified information about a company's community and political effects in the United States and elsewhere."[177] The hope of such social disclosure is that it will influence companies to behave in a responsible manner that not only complies with existing laws but is ethical.[178]

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173. Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities Act Release No. 6835, 43 SEC Docket 1330, 1344 (May 18, 1989).

174. *See, e.g.*, Caterpillar Inc., *supra* note 170.

175. In some industries, the MD&A is used to disclose helpful quantitative information. For example, retail firms disclose data such as the number of store openings and closings. *See, e.g.*, Cathy J. Cole & Christopher L. Jones, *The Usefulness of MD&A Disclosures in the Retail Industry*, 19 J. ACCT., AUDITING & FIN. 361, 364 (2004).

176. *See* 17 C.F.R. §§ 229.103, 229.402 (2019).

177. *See, e.g.*, Cynthia Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1273–74 (1999).

178. Another argument is that disclosure serves not only the interests of investors but a broader range of stakeholders. *See* Ann M. Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, 37 YALE J. ON REG (forthcoming), https://ssrn.com/abstract=3435578 [https://perma.cc/36BP-H3JP] (last revised Nov. 6, 2019).

Recently, there has been increasing support of social disclosure requirements. The EU has adopted a directive relating to public company disclosure on a wide range of social issues.[179] In the United States, significant institutional investors are increasingly seeking and incorporating social disclosure in their decision-making.[180] The SEC is considering whether it should expand increasing mandatory social disclosure.[181] Professor Jill Fisch has proposed requiring companies to provide a narrative description of major environmental issues similar to the MD&A.[182]

There is a substantial argument that social disclosure could shape corporate behavior. First, the exercise of gathering information could inform the corporation when its behavior is not socially optimal. Mandatory rules would provide a business rationale for collecting data on its social impact. Corporate managers who prefer socially desirable policies can use such information to spur organizational change. A company may also discover by assessing this information that certain socially undesirable practices adversely affect its earnings. Second, disclosure of social information could allow investors or other parties to highlight companies that are generating excessive social costs.[183] Good disclosure could provide activists with ammunition to use corporate governance mechanisms to pressure companies to reform.

The question is whether social disclosure requirements will do more than effectuate change at the margins. So long as managers face pressure to deliver quarterly profits, they will prioritize shareholder wealth over other concerns. As noted earlier, financial projections and disclosures are simple heuristics that are easy for markets to quickly digest and quickly incorporate into market prices. Narrative descriptions can provide useful information but are likely to be dominated by quarterly results. Even if they personally value social issues,[184] managers of institutional investors have obligations and pressure to deliver strong returns.[185]

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179. *See* Directive 2014/95/EU, of the European Parliament and of the Council of 22 October 2014 Amending Directive 2013/34/EU as Regards Disclosure of Non-Financial and Diversity Information By Certain Large Undertakings and Groups, 2014 O.J. (L 330).

180. *See, e.g.*, Cynthia A. Williams & Jill E. Fisch, Request for Rulemaking on Environmental, Social, and Governance (ESG) Disclosure, No. 4-730, at *8 (Oct. 1, 2018), https://www.sec.gov/rules/petitions/2018/petn4-730.pdf [https://perma.cc/GUG4-WX8A].

181. Press Release, SEC, SEC Proposes to Modernize Disclosures of Business, Legal Proceedings, and Risk Factors Under Regulation S-K (Aug. 8, 2019), https://www.sec.gov/news/press-release/2019-148 [https://perma.cc/KDV7-EQXR].

182. *See, e.g.*, Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 107 GEO. L.J. 923 (2019) (describing proposals and proposing sustainability discussion and analysis section for the annual report).

183. *See, e.g.*, Williams, *supra* note 177, at 1294–95.

184. *See, e.g.*, Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L. FIN. & ACCT. 247 (2017) (arguing that shareholder welfare includes social preferences).

185. The evidence that sustainable practices are correlated with market performance is questionable at best. *See, e.g.*, Dan Esty & Todd Cort, *Corporate Sustainability Metrics: What Investors Need and Don't Get*, 8 J. ENVTL. INVESTING 11, 15 (2017) ("We survey a wide range of studies and analyses—and find the data and conclusions about the correlation between sustainability and marketplace success to be divergent.").

Perhaps a solution would be for the SEC to create an index that measures social responsibility that could be used to evaluate companies. Some investment firms have already constructed such indices.[186] A problem is that while an index may provide useful information, its value is unlikely to meaningfully change on a frequent basis. Unlike earnings numbers that change each quarter, a social responsibility index would not often convey new information about a company that would spur reevaluation of a company's prospects. Thus, it would not be as influential as quarterly earnings reports to transacting investors.[187]

Moreover, it is difficult to compel companies to provide meaningful social disclosure. Companies tend to paint themselves in a generally positive light. Without clear and meaningful metrics, social disclosure will not provide much detail about a company's practices. Because it is difficult to link incomplete social disclosure with stock losses, the failure to provide meaningful social disclosure would not trigger private securities litigation. The SEC would need to bring enforcement cases for companies to have a significant regulatory incentive to provide meaningful disclosure.

D. Fixing Quarterly Projections

Much of the pressure on public companies from the quarterly reporting system comes from the compulsion to meet quarterly projections, but there has been little consideration of whether the SEC should increase regulation relating to such projections. Rather than changing the frequency of disclosure, it could seek to reduce the pressure of projections on public companies. This would require the SEC to increase rather than reduce its regulation of quarterly disclosure. If the source of problematic projections is private ordering, government intervention could help reconfigure such arrangements.

1. Banning Company Projections

Because projections are typically developed by research analysts, companies and regulation have a limited ability to influence them. However, as some commentators have noted, companies might reduce the importance of projections by refusing to issue their own guidance with respect to projections.[188] Analysts will

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186. *See, e.g.*, Meir Statman, *Socially Responsible Indexes*, 32 J. PORTFOLIO MGMT. 100, 101–04 (2006); *see also* DANA BRAKMAN REISER & STEVEN A. DEAN, SOCIAL ENTERPRISE LAW: TRUST, PUBLIC BENEFIT, AND CAPITAL MARKETS 124–32 (2017) (discussing metrics for social performance).

187. *See, e.g.*, Bill Davis et al., *Performance and Impact: Can ESG Equity Portfolios Generate Healthier Financial Returns?*, 8 J. ENVTL. INVESTING 252, 254 (2017) ("For portfolio managers focused on short-term returns, issues around data quality, availability, materiality, and diversification taken together have given ample reasons to avoid inclusion of ESG inputs.").

188. *See, e.g.*, THE ASPEN INST., LONG-TERM VALUE CREATION: GUIDING PRINCIPLES FOR CORPORATIONS AND INVESTORS ¶¶ 2.1-2.2 (2010) (proposing that managers avoid quarterly guidance and instead communicate long-term plans); Dimon & Buffett, *supra* note 3; Fuller & Jensen, *supra* note 139, at 44 ("[M]anagers can refuse to collude with analysts' expectations when they don't fit with their strategies and the underlying realities of their markets.").

typically use the company's forecasts to develop their own projections. If analysts did not have company guidance, then projections might be viewed as less reliable, perhaps making it less important for companies to meet them.

The SEC could support and accelerate this process by going back to its old policy of discouraging company projections. It could scale back the litigation safe harbor for projections, creating the fear of liability for companies that issue unrealistic projections.[189] It could ramp up enforcement efforts to prohibit or discourage companies from communicating with analysts in private about their projections. It might even prohibit the inclusion of company projections in SEC filings.

A problem with this approach is that analysts will likely continue to generate and rely on their own projections, even if they are less reliable.[190] Projections initially arose from the securities industry and would persist even if the SEC were to discourage them. Reducing company guidance with respect to projections could result in more volatility in markets. It might also create even more pressure from companies to deliver quarterly results that meet projections that they do not have the opportunity to influence.

2. Mandating Projections

Rather than reducing company communication relating to projections, the SEC could mandate more communication. When the SEC initially considered changes to its policy of prohibiting projections in the 1970s, it looked at proposals to require all public companies to make projections and include them in their SEC

189. *See, e.g.*, ROGER L. MARTIN, FIXING THE GAME: BUBBLES, CRASHES, AND WHAT CAPITALISM CAN LEARN FROM THE NFL 82 (2011) (arguing that PSLRA safe harbor "plainly encourages and facilitates the penetration of the expectations market into the real market by giving executives a powerful tool for expectations manipulation" and "should simply be repealed").

190. A more radical approach would be to make analysts liable for inaccurate projections. If analysts set projections too high, and the company does not meet them, the analyst could be liable for some of the investor losses. Such a policy would create incentives for analysts to issue more conservative projections.

filings.[191] Some commentators also argued that companies should be required to disclose the assumptions they used in calculating such projections.[192]

If public companies were required to issue projections, the process by which projections are developed would be more transparent. Public corporations would have to take a clear position about their future performance that could be assessed by investors. They would have an incentive to be cautious in issuing such projections because they would be more directly accountable for meeting them. Company projections could lower expectations when analyst projections are too ambitious and pressure companies to deliver unrealistic results.[193]

Early proposals to mandate projections failed in part because of the concern that many companies were not equipped to accurately project their earnings. But public companies and their regulation have changed since the 1970s. After Sarbanes-Oxley, only companies with the resources to implement and assess internal controls can achieve and maintain their public status. As expectations for public companies have changed, it is worth reconsidering whether mandatory projections would be feasible.[194] Even if it is too difficult for companies to issue a precise number, regulation could permit companies to disclose ranges of potential outcomes.

One concern might be that requiring companies to disclose projections would mean that some companies would attempt to deceive investors by issuing unrealistically high projections. But if companies were required to disclose the basis behind the projection, it would reduce the risk that a projection is not rooted in

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191. *See* Notice of Proposed Rules and Forms on Earnings Projections, Exchange Act Release No. 5,581, 6 SEC Docket 746 (Apr. 28, 1975); *see also* Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 780–87 (1995) (describing proposal and its rejection). In the accounting literature, there were proposals for companies to disclose their internal budgets and forecasts. *See, e.g.*, W.W. Cooper et al., *Budgetary Disclosure and Other Suggestions for Improving Accounting Reports*, 43 ACCT. REV. 640 (1968). Proposals to mandate disclosure of projections have continued to be made. *See, e.g.*, Roger J. Dennis, *Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective*, 46 MD. L. REV. 1197 (1987) (proposing mandatory disclosure of proposals with respect to change of control transactions); Lipton & Rosenblum, *supra* note 7, at 234 (proposing companies issue five year report that would "detail the corporation's five-year business plan, including projections, the assumptions underlying them, the factors likely to affect whether the projections are met, and the corporation's ability to control or influence these factors."); Note, *Disclosure of Future-Oriented Information Under the Securities Laws*, 88 YALE L.J. 338, 338 (1978) (proposing "formal disclosure of financial forecasts by management").

192. *See, e.g.*, John G. Gillis, *Legal Aspects of Corporate Forecasts*, 29 FIN. ANALYSTS J. 72, 74 (1973) (proposing guidelines for disclosing assumptions behind forecasts); William S. Gray III, *Proposal for Systematic Disclosure of Corporate Forecasts*, 29 FIN. ANALYSTS J. 64, 69 (1973) ("[E]very forecast statement should include a statement of the assumptions on which the forecast is based."); Reiling & Burton, *supra* note 70, at 53 ("A forecast should be accompanied by a statement of the major economic and operating assumptions underlying its preparation.").

193. *See, e.g.*, Reiling & Burton, *supra* note 70, at 50 ("Company forecasts would at least provide a check on the enthusiasm of some transported professionals.").

194. Chinese securities regulation mandates that companies issue projections and requires sanctions if such projections are not met. *See, e.g.*, Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China's Securities Market*, 108 COLUM. L. REV. 929, 952 n.86 (2008) (finding twenty percent of sanctions imposed by Chinese securities exchanges were for failure to meet projections).

reality. While it might be initially difficult to develop rules governing the assumptions that should be disclosed,[195] over time, industry standards could develop. The disclosure of forecast assumptions is not unprecedented. The United Kingdom Takeover Code has required since the 1960s that any "profit forecast . . . must include the principal assumptions on which the profit forecast is based."[196] Credit rating agencies publish extensive guides to the methodology they use in predicting the risk a company will default on its debt.[197]

Another concern is that if all companies issue projections, there will be an increase in securities litigation directed at those companies that miss a projection. Even if managers are cautious in developing forecasts, there will be cases where they will not be met. However, as noted earlier, the current safe harbor only permits liability when a projection is knowingly false and not accompanied by meaningfully cautionary language. This provision should be sufficient to deter suits that do no more than allege that a company projection has not been met. If that safe harbor proves insufficient, it could be bolstered to reduce frivolous litigation.

It is uncertain whether mandating company projections would result in a system where projections do not set unrealistic expectations. Even if companies issue projections, analysts could still come to a different consensus. If corporate projections are understood as being overly cautious, then analysts would create their own forecasts that companies would feel pressured to meet. On the other hand, if companies were required to take a clear position with respect to their quarterly projections, they would be forced to take more control over the way that short-term expectations are set. Rather than complaining that they are subject to unfair short-term metrics while benefitting from high market expectations about their future performance, corporate managers would have to provide investors with a realistic assessment of their upcoming quarterly results.

Instead of reducing the frequency of disclosure, the SEC should seriously consider whether increasing disclosure relating to public company projections would be a way of checking short-termism.

195. The need for transparency would have to be balanced with the risk that disclosure of assumptions would help the issuer's competitors. *See, e.g.*, Asher v. Baxter Int'l Inc., 377 F.3d 727, 733 (7th Cir. 2004) (observing that while "investors would like to have . . . full disclosure of the assumptions and calculations *behind* the projections . . . [m]any of the assumptions and calculations would be more useful to a firm's rivals than to its investors").

196. THE PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS K5 (12th ed. 2016) (U.K.), http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf [https://perma.cc/PY5Z-6GSN]. Indeed, supporters of permitting projections in SEC filings in the 1970s pointed to the UK example. *See, e.g.*, John Hull, *Profit Forecasts—The English Experience*, *in* PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS, *supra* note 14, at 19, 20, 29.

197. *See, e.g.*, Partnoy, *supra* note 113, at 1445–72 (describing methodologies and their flaws).

3. A More Vigorous Duty to Correct

Another way of addressing problems caused by market expectations that are set too high would be to increase the duty of public companies to correct unrealistic projections made by third parties. If analyst projections are materially overoptimistic, a public company could be required to respond by issuing a more realistic projection. Courts have generally required companies to "update opinions and projections . . . if the original opinions or projections have become misleading as the result of intervening events."[198] This duty has been generally applied only to projections issued by a company and it could be extended to require companies to intervene when it knows that analyst projections are unrealistic.[199] While there would be a concern of increasing the liability faced by public companies,[200] courts and the SEC could limit such suits to cases where management failed to act despite a high degree of knowledge that an external projection is too high. Many companies already preempt projection misses, but others may be wary of doing so because they want to fuel market optimism. A stronger duty to disclose could help increase the incentive of companies to correct analyst forecasts.

On the other hand, such a duty to correct would be difficult to implement. At the time an analyst projection is made, a company may not know that it is unrealistic. Managers will have to make difficult judgment calls about when to issue an update. It will be challenging to determine when the failure to update is made in good faith or not. Private litigation would increase and would often not clearly resolve whether the duty was violated.

* * *

Of the four proposals to address the short-termism of quarterly reporting, the most promising is to encourage transparency and collaboration between investors and issuers in setting quarterly projections. Rather than reduce the frequency of periodic disclosure, increasing disclosure obligations with respect to projections should be explored as a way of reducing the problem of short-termism. Such reform of projections, though, poses its own challenges, and it is far from clear that securities law can effectively check short-termism in public companies.

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198. *In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 267 (2d Cir. 1993); *see also* Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1644, 1665–71 (2004).

199. The possibility that issuers should have some obligation to correct analyst forecasts has been long noted. *See* FAF Special Comm. on Corp. Forecasts, *Proposals by the Federation for Systematic Disclosure*, *in* DISCLOSURE OF CORPORATE FORECASTS TO THE INVESTOR, *supra* note 80, at 26 ("[I]t is often desirable for management to make public correction of published forecasts by analysts or other outsiders which vary substantially from internal estimates.").

200. Courts have thus differed with respect to how broadly they read the duty to update company projections. *Compare In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1432–33 (3d Cir. 1997) (noting that broad duty to update projections would "deter companies from providing this information—a result contrary to the SEC's goal of encouraging the voluntary disclosure of company forecasts"), *with* Stransky v. Cummins Engine Co., 51 F.3d 1329, 1333 (7th Cir. 1995) ("[C]urrent SEC policy contradicts the rationale that investors do not rely *at all* on projections.").

IV. STRONG SECURITIES LAW AND WEAK CORPORATE LAW

Quarterly disclosure is part of a system of securities regulation that has increasingly promoted the interests of transacting investors. Public companies are also governed by corporate law, which gives a corporation significant freedom to consider its long-term interests. Some of the short-term pressure created by strong securities law is checked by corporate law that only weakly regulates the discretion of corporate managers.[201] Moreover, some of the weakness of corporate law is made possible by the increasing strength of securities law. Because securities regulation favors transacting investors, Congress and the SEC should be cautious in increasing the power of short-term shareholders through federal corporate law.

A. The Securities Laws and Short-termism

The primary purpose of the securities laws is to protect investors. But as I argued extensively in an earlier article, this protection primarily extends to the subset of transacting investors—those who purchase or sell securities.[202] For example, only an investor who buys a stock while it is inflated by fraud can recover damages under Rule 10b-5.[203] Because it focuses on facilitating fair transactions, securities regulation tends to further the interests of short-term investors who transact more frequently than long-term investors.

The mandate of quarterly disclosure particularly favors investors with shorter time horizons. Shifting to annual or semiannual disclosure would mean that valuations would be less accurate throughout the year than with quarterly disclosure. Investors who buy and hold a stock for years are less concerned that its market price is accurate on a quarterly basis than investors who are constantly trading on new developments that affect a company's prospects.[204] Information traders who seek to predict the short-term performance of a public corporation can profit from frequent disclosure events. Investors that trade frequently also benefit from the lower volatility and trading spreads associated with disclosure.[205] Even though

201. In noting the weakness of corporate law in regulating the discretion of managers, I do not mean to suggest that all aspects of corporate law are weak or should be weak. For example, corporate law does not confer managers the discretion to steal from the company and such a strong prohibition is necessary even with strong securities law.

202. *See* Park, *supra* note 15.

203. Thus, only an investor who purchases or sells a security can bring a claim for securities fraud under Rule 10b-5. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975).

204. *See, e.g.*, Arthur Fleischer, Jr. et al., *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 803 (1973) (noting that "market information is primarily relevant to short-term traders").

205. Disclosure increases confidence in the market price of a stock and lowers the transaction costs at which trades will occur. *See, e.g.*, Paul M. Healy et al., *Stock Performance and Intermediation Changes Surrounding Sustained Increases in Disclosure*, 16 CONTEMP. ACCT. RES. 485 (1999) (finding higher returns and liquidity for firms that increase disclosure); Christian Leuz & Robert E. Verrecchia, *The Economic Consequences of Increased Disclosure*, 38 J. ACCT. RES. 91 (2000) (finding lower bid-ask spreads for German firms that committed to greater disclosure); Michael Welker, *Disclosure Policy,*

mandatory disclosure can be used by a wide range of investors and even stakeholders, frequent traders have the most need for quarterly disclosure.

In addition to quarterly disclosure, other securities law policies can have the unintended effect of promoting short-termism. For example, as institutional investors increased their trading, they pushed the SEC to eliminate the fixed commissions charged by exchanges.[206] After the SEC prohibited fixed commissions in 1975,[207] the resulting decline in commission rates drove down the costs of trading and increased market participation.[208] A little more than a decade later, criticism arose about how the increase in trading volume had negative effects such as pressuring corporate managers to focus on short-term performance, resulting in proposals for a tax on securities transactions.[209] While few would agree that we should go back to markets with high transaction costs, policies that benefitted transacting investors put pressure on corporate managers to constantly satisfy the market.

The fraud-on-the-market presumption is another example of a securities law doctrine that favors short-term investors. Rather than requiring a showing that a purchaser read a misleading disclosure document, the presumption allows reliance by the purchaser on the integrity of the market price of a stock that trades in an efficient market.[210] Even though a stock price is not precisely accurate at every point in time, this presumption enables investors to argue they were entitled to assume that the price at which they transacted was not inflated by fraud.[211] Short-term investors are more likely to be in a position to invoke the fraud-on-the-market presumption because they are more likely to have purchased stock during the period of fraud. Long-term investors are less likely to have transacted during the period of fraud but bear part of the costs of defending the securities class action made possible by the presumption.[212]

It is important to acknowledge that some aspects of securities regulation also serve the interests of long-term shareholders. Mandatory disclosure allows all

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Information Asymmetry, and Liquidity in Equity Markets, 11 CONTEMP. ACCT. RES. 801 (1995) (finding negative relationship between disclosure and bid-ask spreads).

206. *See* Fixed Commission Rates on Exchange Transactions, Exchange Act Release No. 11,093, 5 SEC Docket 438, 439–48 (Nov. 8, 1974).

207. *See* Adoption of Securities Exchange Act Rule 19b-3, Exchange Act Release No. 11,203, 6 SEC Docket 138, 155–56 (Jan. 23, 1975).

208. *See, e.g.*, Jason Zweig, *Lessons of May Day 1975 Ring True Today: The Intelligent Investor*, WALL ST. J. (Apr. 30, 2015), https://www.wsj.com/articles/lessons-of-may-day-1975-ring-true-today-the-intelligent-investor-1430450405 [https://perma.cc/C5PM-Y4L9] (observing that after deregulation of commissions, "[t]rading boomed, investors flocked back to the markets and brokerages minted money for decades").

209. *See, e.g.*, Stiglitz, *supra* note 146; Summers & Summers, *supra* note 109. The proposal to tax securities transactions continues to be occasionally floated. *See, e.g.*, THE ASPEN INST., OVERCOMING SHORT-TERMISM, *supra* note 151, at 3.

210. *See* Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 277–78 (2014).

211. *Id.* at 268.

212. James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 336–38 (2009) (describing transfer from non-class shareholders to class shareholders).

shareholders to monitor managers. Anti-fraud prohibitions deter companies from destroying value through short-term accounting fraud. And as noted earlier, there are efforts to reformulate securities disclosure so that it promotes social goals.

Nonetheless, as securities regulation has expanded its reach over the decades, it has generally strived to make market prices as accurate as possible. Protecting investors has had the effect of subjecting public companies to a system where they must take care to consistently deliver results that satisfy the expectations of short-term investors.

B. Balancing Securities Law and Corporate Law

In contrast to securities law, which looks after the interests of investors when they purchase or sell a stock, corporate law protects the interests of investors while they own a stock.[213] Rather than narrowly policing the fairness of transactions, corporate law must look after the diverse interests of all shareholders—some of which are short-term holders, others of which are long-term holders.[214] This point was recognized as early as the late 1970s, with the Business Roundtable explaining that "[t]he owners have an interest in balancing short-range and long-term profitability, in considering the political and social viability of the enterprise over time and in adjusting to the global environment in which it operates."[215] Even as securities regulation has evolved so that it increasingly favors transacting investors, corporate law has given managers significant discretion to consider a public corporation's long-term interests. Weak corporate law can balance strong securities law.[216]

1. State Corporate Law

States that competently strike the right balance between competing interests should be more attractive for corporations that seek jurisdictions with the best regulation.[217] A state like Delaware, which dominates the competition,[218] must be careful not to systematically favor one set of investors over another. Moreover, as

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213. *See* Park, *supra* note 15, at 137.

214. *See id.*

215. Bus. Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2099 (1978). Professors Barzuza and Talley model the tension between long-term and short-term interests and suggest that such interests may counteract each other within the corporation. *See* Michal Barzuza & Eric Talley, *Short-Termism and Long-Termism* 45–46 (Columbia Law & Econ., Working Paper No. 526, 2016), https://ssrn.com/abstract=2731814 [https://perma.cc/3438-VBJQ].

216. Some Delaware judges have noted that Delaware can play a role in encouraging a long-term corporate focus. *See, e.g.*, Jacobs, *supra* note 25, at 1660–64 (proposing role for Delaware in reviving "patient capital").

217. On the benefits of state competition for charters, see generally ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993); Roberta Romano, *The States As a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209 (2006).

218. *See, e.g.*, Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 553–54 (2002).

Professor Mark Roe has demonstrated, the dynamic of state competition is complicated by the presence and possibility of federal regulation.[219]

The structure of state corporate law better enables it to balance short-term and long-term interests than federal securities law. Partly because of its need to consider diverse interests,[220] important aspects of corporate law are framed as broad standards that are applied by judges to particular disputes.[221] Professor Edward Rock describes Delaware case-by-case decision-making as conveying guidance to parties while retaining the flexibility to decide future cases.[222] Such standards can be read broadly or narrowly depending on the circumstances. In contrast, securities law is mainly concerned with the goal of facilitating fair transactions. Specific regulations can provide the clarity necessary to achieve that goal. Thus, important policies such as periodic disclosure are implemented through rules about the frequency and content of reports rather than through a broad standard instructing companies to disclose material information whenever they believe it is appropriate.[223]

As markets have become increasingly focused on short-term performance, and securities regulation increased pressure on managers to deliver results, state corporate law has prevented short-termism from substantially distorting corporate decision-making. It has shielded managers so they are not judged as quickly when they fail to meet short-term forecasts. Moreover, as policies like quarterly disclosure protect the interests of transacting investors, there is less need for corporate law to provide such protection.

a. Weak Corporate Law as a Check on Strong Securities Law

State corporate law has often been criticized for entrenching managers. However, such an approach is on firmer footing with the rise of markets that favor short-term interests. In the 1980s, the approval by Delaware courts of managerial discretion to implement strong takeover defenses was a response to an environment where hostile bidders were increasingly aggressive in making unsolicited bids for

219. *See, e.g.*, Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 635 (2003) ("[T]he state race analysis must be inconclusive because we live in a federal system.").

220. It is worth noting that there are other reasons why corporate law is ambiguous. *See, e.g.*, Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1421–32 (2008) (contending that ambiguity of corporate law reflects ambivalence about the consistency of shareholder and societal interests); Lynn M. LoPucki, *Corporate Charter Competition*, 102 MINN. L. REV. 2101, 2145–49 (2018) (arguing that ambiguity allows Delaware to avoid criticism).

221. While Delaware doctrine can also set forth clear rules, such rules often have exceptions or judges can interpret the facts so that the rules do not apply.

222. *See* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1016–19 (1997).

223. Some elements of securities regulation, though, are set forth through broadly worded principles. *See, e.g.*, James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625, 642–62 (2007) (describing examples of principles-based securities enforcement).

control of public companies.[224] There was a fear that in certain circumstances, bids made in reference to the current market price could undervalue a company. Delaware courts thus recognized that managers can consider the promise of a long-term strategy in rejecting an offer[225] and only in limited circumstances must sell the company for the highest price available.[226] State takeover statutes made it even more difficult for hostile bids to succeed, tilting the balance towards managers.[227]

As the number of hostile takeover bids declined in the 1990s, quarterly earnings projections provided markets with a new way of pressuring managers to maximize short-term performance.[228] But state corporate law gives them significant discretion to resist short-term pressure. Even when a company sees its stock price fall when it misses a quarterly earnings projection, takeover defenses permit it to resist for some time an opportunistic hostile bidder. The business judgment rule will protect managers from shareholder suits seeking damages for such a decline.[229]

It is notable that corporate governance has recently innovated to provide public companies with even more insulation from short-term pressures caused by projections and other sources. Dual-class stock that gives founders control of the governance of a corporation regardless of their economic stake in the company can be understood as motivated by concern that markets will discount the long-term strategies of innovative technology companies.[230] Academic proposals to give long-term shareholders more voting power than short-term shareholders reflect a sense that markets have become too disruptive.[231] State corporate law has generally not intervened at this point to prohibit such corporate governance innovation.

Whether or not these new corporate governance developments are the product of a genuine concern about problematic incentives caused by short-term pressure or the selfish interests of managers is difficult to assess. There are good arguments on both sides about whether corporate law and governance has shifted

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224. *See, e.g.*, Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 873–79 (2002).

225. *See* Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1153 (Del. 1990).

226. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

227. *See, e.g.*, Guhan Subramanian et al., *Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1988–2008*, 65 BUS. LAW. 685, 705 (2010).

228. Activist shareholders have also played a role in generating such pressure. *See, e.g.*, Strine, *supra* note 7, at 8. However, the impact of activist shareholders is not as pervasive as that of earnings projections.

229. *See, e.g.*, Stephen M. Bainbridge, *The Business Judgment Rule As Abstention Doctrine*, 57 VAND. L. REV. 83 (2004).

230. *See, e.g.*, Bradford D. Jordan et al., *Growth Opportunities, Short-Term Market Pressure, and Dual-Class Share Structure*, 41 J. CORP. FIN. 304 (2016) (testing hypothesis that dual class shares reduce short-term pressure); *cf.* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 580 (2016) (arguing that concentrated ownership addresses "[t]he risk of investors disrupting the entrepreneur's pursuit of her idiosyncratic vision exists even when the firm is publicly traded and investors are using stock prices as a proxy for the firm's performance").

231. *See, e.g.*, Lynne L. Dallas & Jordan M. Barry, *Long-Term Shareholders and Time-Phased Voting*, 54 DEL. J. CORP. L. 541 (2015).

too far in one direction.[232] However, to the extent that securities regulation favors short-term investors, there is a stronger justification for corporate law that gives managers broader discretion to implement long-term policies.

The competition for corporate charters led early critics of state regulation of corporate law to hypothesize that Delaware had an incentive to favor managers at the expense of shareholders. Greater protection through expansion of the securities laws was the solution to weak state corporate law. But as the quarterly reporting system has evolved, the core mandates of the securities laws have been successful in supporting markets that vigorously monitor the performance of managers. It is possible to view Delaware law and its deference to the authority of corporate boards more favorably in this world. There is an argument that weak corporate law is essential to balancing strong securities law.

b. Strong Securities Law Allows for Weak Corporate Law

Another way of thinking of the relationship between corporate and securities law is that as securities law has grown stronger, there is less of a need for corporate law to protect investors. If securities law became weaker through the elimination of quarterly disclosure, state corporate law would likely have to do more to protect investors.

Strong securities law has emerged as an enabler of corporate governance. As Professor Jeffrey Gordon has argued, as markets became more efficient, they helped enable independent directors to better monitor managers.[233] Such efficiency, in part, can be traced to securities law reforms in the 1970s that made trading less costly and disclosure more uniform and reliable. In turn, as Professors Kahan and Rock have noted, as corporate governance has improved, there is less reason to worry about the weak corporate law reflected by takeover defenses.[234]

Delaware's recent law on appraisal illustrates how the quarterly reporting system can lessen the need for investor protection that might be provided by corporate law. The availability of appraisal rights ensures that the interests of minority shareholders are protected when a board decides to sell a company. In an appraisal proceeding, objecting shareholders argue to the court that the offered consideration does not represent the "fair value" of those shares.[235]

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232. *Compare* Bebchuk, *supra* note 6, at 1679–81 (describing how board insulation can result in long-term harm to corporation), *with* Martijn Cremers et al., *Activist Hedge Funds and the Corporation*, 94 WASH. U. L. REV. 261, 270 (2016) (proposing "changes to revitalize board authority to resist activist attacks"). *But see* Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 473 (2014) (observing that the evidence may support the conclusion "that the current status quo, with all of its real world human blemishes, strikes, as a general matter, a reasonable balance between stockholder and management power").

233. *See* Gordon, *supra* note 34.

234. Kahan & Rock, *supra* note 224.

235. *See* Del. Code Ann. tit. 8, § 262(h) (2019).

In a series of recent decisions, the Delaware Supreme Court held that when a company's stock trades in an efficient market, its market value should be given significant weight in determining its fair value.[236] In the appraisal case arising out of the management buy-out of the computer company Dell, the court reversed the Court of Chancery's decision awarding a higher price to objecting shareholders based on its own discounted cash flow analysis.[237] In doing so, it noted Dell's inability to sell its "long-term vision" of the company while "it kept failing the quarterly tests on which so many market analysts focus."[238] The court concluded that the Court of Chancery's "failure to give the resulting [deal] price heavy weight" was an abuse of discretion.[239]

The court thus assumed that the quarterly reporting system was the best way of measuring the adequacy of the deal price.[240] But in emphasizing the market's assessment of a company's performance through projections, the court accepted without question the reliance of the market on short-term performance metrics.[241] The court did not recognize in its opinion the potential inadequacy of such metrics,[242] rejecting the Court of Chancery's argument that "'investor myopia' created a valuation gap" that distorted the deal price.[243]

Regardless of whether Delaware's recent emphasis on market value in appraisal cases is warranted,[244] it is possible in part because of the work of the

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236. *See* Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd., 177 A.3d 1, 6 (Del. 2017); DFC Glob. Corp. v. Muirfield Value Partners, L.P., 172 A.3d 346, 369-72 (Del. 2017); *see also* James D. Cox & Randall S. Thomas, *Delaware's Retreat: Exploring Developing Fissures and Tectonic Shifts in Delaware Corporate Law*, 42 DEL. J. CORP. L. 323, 328 (2018) (concluding that "existing market forces and shareholder oversight are sufficient to curtail managerial misconduct but that the watchful eye of judicial review may need to be revived if those vehicles for shareholder oversight are curtailed").

237. *See Dell, Inc.*, 177 A.3d at 5.

238. *Id.* at 10.

239. *Id.* at 35.

240. For a critique of this position, see Charles Korsmo & Minor Myers, *The Flawed Corporate Finance of* Dell *and* DFC Global, 68 EMORY L.J. 221 (2018). *But see* Jonathan Macey & Joshua Mitts, *Asking the Right Question: The Statutory Right of Appraisal and Efficient Markets* (European Corp. Governance Inst., Working Paper No. 428, 2018), https://ssrn.com/abstract=3279838 [https://perma.cc/SY65-CTXW].

241. The Court also looked to a company's short-term performance in a later case, noting that a bidder knew of a target's strong quarterly performance in making its bid before the results were released to the market in concluding that the market price undervalued the company. *See* Verition Partners Master Fund Ltd. v. Aruba Networks, Inc., C.A. No. 11448–VCL, 2018 WL 922139, at *20–21 (Del. Ch. Feb. 15, 2018).

242. Managers seeking to take a company private have an incentive to manipulate projections and performance downwards to drive the market price down. Though there may not be evidence that such a dynamic was at play in the *Dell* case, there is an argument that courts should closely scrutinize management buyouts. *See* Iman Anabtawi, *Predatory Management Buyouts*, 49 U.C. DAVIS L. REV. 1285, 1325–29 (2016).

243. *Dell, Inc.*, 177 A.3d at 16.

244. The Delaware Supreme Court's recent appraisal decisions can be understood as a reaction against speculators who purchase stock to bring appraisal claims. *See, e.g.*, Charles R. Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. 1551, 1572–73 (2015). If appraisal claims were mainly brought by long-term shareholders, there might be more sympathy for such claims. There is evidence that these claims have merit, *see, e.g.*, *id.* at 1594–95

securities laws in facilitating the short-term efficiency of markets. If quarterly disclosure were eliminated, there would be a case for stronger appraisal rights because there would be less confidence that market prices would reflect the fundamental value of the company. Delaware doctrine has thus been shaped in some ways by the efforts of the securities laws and would be affected if those laws were to change.

2. Federal Corporate Law

In a provocative article, Professors Goshen and Hannes recently announced *The Death of Corporate Law*.[245] They contend that as shareholders have become more sophisticated, they have less need for corporate law. While their thesis may hold with respect to the state corporate law created by Delaware courts, it does not with respect to the corporate law provisions that are increasingly part of the federal securities laws. Such federal corporate law has significantly expanded over the last couple of decades.

Indeed, the influence of institutional shareholders has been a significant driver of corporate law that has increased the obligations of public companies. In the wake of the securities frauds of the early 2000s, and the financial crisis of the late 2000s, Congress sought to reassure investors by passing federal legislation to reduce the risk of fraud and mismanagement. Public companies were required to increase the independence of their boards in verifying the accuracy of financial statements and approving executive compensation packages.[246] Shareholders were granted the right to periodically opine on executive compensation packages.[247] Such legislation reflected the desire of investors to play a greater role in corporate governance.[248] Far from relying on their own abilities to monitor, some investors have demanded protection through governance reforms that increase shareholder power.[249]

There have been many objections to the expansion of federal corporate law. This Article's analysis provides an additional reason to limit the use of the federal

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(presenting evidence that appraisal claims tend to target deals with lower premiums), but the optics of benefitting speculators has made it difficult for Delaware to encourage such claims.

245. Zohar Goshen & Sharon Hannes, *The Death of Corporate Law*, 94 N.Y.U. L. REV. 263 (2019).

246. *See* SARBANES-OXLEY ACT OF 2002 § 301, 15 U.S.C. § 78j-1 (2010); DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT § 952, 15 U.S.C. § 78j-3 (2010).

247. *See* DODD-FRANK ACT § 951.

248. *See, e.g.*, Christopher M. Bruner, *Center-Left Politics and Corporate Governance: What Is the "Progressive" Agenda?*, 2018 BYU L. REV. 267, 289 (noting that Dodd-Frank reforms increasing shareholder power were sought by union pension funds); Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1, 2 (2004) ("In the wake of recent corporate scandals, institution[al investors] have been demanding more rights, for example, more rights with respect to the nomination of corporate directors."); *see also* James J. Park, *The Limits of the Right to Sell and the Rise of Federal Corporate Law*, 70 OKLA. L. REV. 159 (2017) (arguing that corporate scandals have created pressure to protect investors from losses caused by corporate mismanagement).

249. *See, e.g.*, Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1353, 1359 (2010) ("Subsidization of investor empowerment through regulatory action aligns with the SEC's mission of investor protection and shareholder primacy.").

securities laws to increase the power of shareholders. The core provisions of federal securities regulation already favor short-term investors. Expanding federal law to increase the corporate rights of shareholders could in some circumstances tilt regulation to decisively favor short-term investors.

For example, consider the example of shareholder proposals. The SEC has long mandated that proposals relating to a company's "ordinary business operations" can be excluded from the company proxy statement.[250] This rule helps ensure that federal proxy regulation does not undermine the corporate law business judgment rule. The SEC has also deferred to the judgment of Delaware in limiting the ability of shareholders to adopt bylaws that go beyond regulating procedural issues.[251] Reformers have proposed increasing the power of shareholders to dictate corporate policy and adopt bylaws.[252]

But given the potency of the quarterly reporting system in monitoring management, it is unclear that shareholders need additional power to check managerial agency costs. Such powers might be abused to favor short-term interests and push through questionable cosmetic changes. On the other hand, shareholder proposals can be used as a mechanism to spur discussion of social and environmental issues that affect the long-term health of the corporation.[253] Thus, in considering shareholder proposal reform, Congress and the SEC should attempt to limit such regulation to measures that facilitate dialogue about issues relating to the long-term health of the corporation rather than its short-term performance.

CONCLUSION

The recent proposals to reform the quarterly reporting system highlight an underexamined and troubling possibility—that the securities laws tend to serve the interests of short-term investors. Securities regulation has not been the only driver of short-termism, but it has supported it in significant ways. This Article has shown that the frequency of disclosure is not as important a driver of short-termism as the projections that now judge managerial performance. Moreover, it is unclear that such short-termism significantly affects public companies except in particular circumstances. Thus, rather than take the radical step of reducing the frequency of periodic disclosure, the SEC should consider more modest reforms such as increasing disclosure relating to projections.

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250. *See* 17 C.F.R. § 240.14a-8(c)(7) (1984).

251. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 235 (Del. 2008).

252. *See, e.g.*, Stephen M. Bainbridge, *Revitalizing SEC Rule 14a-8's Ordinary Business Exclusion: Preventing Shareholder Management by Proposal*, 85 FORDHAM L. REV. 705, 719–24 (2016) (describing efforts to read business operations exclusion narrowly); Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, 106 CAL. L. REV. 373, 402–03 (2018) (noting conflicting views about increasing power of shareholders to adopt bylaws).

253. *See, e.g.*, TONELLO, *supra* note 17, at 15 ("Shareholder proposals have become the tool preferred by institutional investors to encourage the discussion of a variety of social, environmental, or corporate governance issues that are intimately connected with the company's long-term strategy and crucial to the health of its business.").

Scholars and policymakers should be attentive to the tendency of securities law to favor short-term investors. As securities law grows stronger, the case that corporate law should give managers discretion to consider long-term interests also becomes stronger. Increasing shareholder power through federal corporate law could give too much power to short-term investors that are already favored by securities law.