Sonderdruck aus

Zeitschrift für Vergleichende Rechtswissenschaft

Archiv für Internationales Wirtschaftsrech

Herausgegeben von

Klaus Peter Berger, Rolf Birk, Werner F. Ebke, Bernhard Großfeld, Susanne Kalss, Peter V. Kunz, Peter Mankowski, Karl Matthias Meessen, Hanno Merkt, Otto Sandrock

The System of Disclosure Obligations in U.S. Capital Market Law

Thomas Jutzi*

ZVglRWiss 109 (2010) 445–494

I. Introduction

The disclosure obligations with which corporations in the United States (U.S.) are required to comply under capital market laws (*i. e.*, securities laws) have become the subject of increasing international attention. This can be explained, in part, by the globalization of companies. U.S. disclosure requirements are, more or less, also applicable to e. g. German and Swiss corporations that are listed on a stock exchange in the U.S. Moreover, U.S. Generally Accepted Accounting Principles (U.S. GAAP) set an internationally prevalent standard for financial accounting. Presently, in Europe, the disclosure obligations of companies in the U.S. are also associated with the compensation of managers. In Germany, for instance, the possible introduction of stricter disclosure obligations concerning the compensation of company directors, has been discussed for quite some time in order to moderate excessive remuneration levels and to hold top managers more accountable. The most important point made here is that increased individual disclosure obligations were introduced in the U.S. in 2002 by the Sarbanes-Oxley Act.[1] Further, cases in which investors secretly obtained commercial positions in listed companies so that they could subsequently influence the company's business strategy or obtain the remaining shares at favorable prices sparked anger.[2] Much is also made here of the regulations in the U.S. In regard to the role model function of U.S. disclosure obligations for various European legal systems, the analysis of the system of disclosure obligations in U.S. Capital Market Law seems to be essential and fruitful. As a general rule, securities regulations in the U.S., specifically the Securities Act of 1933 (also known as the "Securities Act" or "1933 Act") and the Securities Exchange Act of 1934 ("Securities Exchange Act" or

* Dr. Thomas Jutzi is an associate with Niederer Kraft & Frey AG, Zurich, Switzerland. He is grateful to Professor *Peter V. Kunz* (University of Berne) and Professor *Richard M. Buxbaum* (University of California at Berkeley) for advice and assistance.

1 See, *e.g.*, *Lindner*, Verordnete Sicherheit, Compliance Magazin 2 (October 19, 2006).

2 *Zetsche*, Verdeckter Anteilsaufbau in börsennotierten Aktiengesellschaften – rechtlicher Handlungsbedarf?, 9 Recht 276, 276–277 (2008); *Jutzi/Schären*, Erfassung von Finanzinstrumenten im revidierten Offenlegungsrecht, 8 ST 570, 575 (2009).

"1934 Act"), contain wide-ranging and comprehensive disclosure obligations and that the SEC strictly supervises compliance with these obligations.[3] Nevertheless the question regarding U.S. disclosure obligations arises whether they have the ability to fulfill their presumed goals, in particular those of offering protection to investors and creditors.

The article will first discuss the development[4] and the functions[5] of disclosure requirements. Subsequently, the legal principles of disclosure and the significance of the SEC and the courts for their development[6] will be analyzed. Thereafter, an overview of the guiding principle of full and fair disclosure[7] and individual affirmative disclosure obligations[8] will be presented. The analysis will be followed by some concluding remarks.[9]

II. Development of Disclosure Obligation Laws

Disclosure obligations for corporations were first provided by detailed legislation in the U.S. in the early 1930s. Thus, within a relatively short period of time, specifically, the period between the founder boom around the mid-19th century and the New Deal of the 1930s, a dramatic development took place: from the almost total absence of any disclosure obligation, to the strictest and most sophisticated system of normative company disclosure.

1. Early Phase and Implementation of General Capital Market Legislation in Several States

In the early years after the foundation of the U.S., the law did not place companies under any kind of obligation to disclose company-related information.[10] Moreover, court rulings and statutory law that emerged only gradually to protect against fraud were applicable only to affirmative statements of fact.[11] Obligations for vendors of goods to disclose information about goods sold were alien to the law. Rather, the principle of *caveat emptor* was applied strictly.[12] In particular, vendors of effects were "under no obligation to communicate anything to anyone", as one court put it in 1857.[13] Until the end of the 19th century, courts even refused to impose disclosure obligations in the event of insider trading.[14] There are, however, reports about individual cases in which companies, in their constitutions, voluntarily accepted the obligation to disclose, on a regular basis, important company data to their shareholders.[15] Thus, for instance, the directors of Merchant's Louisville Insurance Company, founded in Kentucky, were obliged to present "a fair and clear statement of the affairs of the company" to the shareholders twice a year.[16] Moreover, there were calls even in early jurisprudence for greater company transparency and disclosure in the U.S.: As early as 1840, for example, *Daniel Raymond* demanded that "every charter ought to provide that statement or balance sheet shall be made out, at least once a year [...], and this balance sheet ought to be accessible to all stockholders".[17] At about the same time, *John O'Connor*, a dedicated campaigner for the interests of small investors, demanded that "every incorporated Company shall quarterly or semi-annually lay before its stockholders & the public a full & exact state of its affairs".[18]

However, it was not until the first decade of the 20th century, with the introduction of public utilities legislation concerning the official authorization of public utility share trading, that specific capital market statutes were enacted by various States.[19] The first State statutes for the general regulation of securities trading (State securities laws) were enacted in 1909 in Nevada and in 1911 in Kansas. The Nevada statute required comprehensive issuance disclosure for the sale of mine shares.[20] The Kansas statute was intended to protect investors against promoters "who would sell building lots in the blue sky in fee simple".[21] The central regulatory idea of this law was to make the authorization of a security conditional on the approval of regulatory law.[22] The statute set extremely strict content standards, or "merit standards", for the prior official assessment.[23] Moreover, issuers were obliged, every six months, to file reports

3 *von Kirchbach*, Publizitätspflichten börsennotierter Gesellschaften in Deutschland und den USA, 2007, pp. 2–4; *Jutzi/Schären* (N.2), 8 ST 570, 575 (2009).
4 See infra II.
5 See infra III.
6 See infra IV.
7 See infra V.
8 See infra VI.
9 See infra VII.
10 *Loss/Seligman*, Fundamentals of Securities Regulation, 2d ed. 1988, p. 4.
11 *Loss/Seligman* (N.10), p. 4.
12 *Merkt*, Unternehmenspublizität: Die Offenlegung von Unternehmensdaten als Korrelat der Marktteilnahme, 2001, p. 115.

13 Cazeaux v. Mali, 25 Barb. 578 (N.Y.App.Div.1857). Exceptions to the principle of *caveat emptor* were permitted only in special circumstances, for instance, if a particular relationship of trust and confidence existed and the vendor maliciously exploited the buyer's ignorance. See Mallory v. Leach, 35 Vt. 156, 166 (1862).
14 Crowell v. Jackson, 23 A. 426 (N.J. 1891); Board of Commissioners of Tippecanoe County v. Reynolds, 44 Ind. 509 (1873).
15 *Watts/Zimmerman*, Agency Problems, Auditing, and the Theory of the Firm, 26 J.Law & Econ. 613, 613–633 (1983).
16 Ky. Laws 1829–30, Chapter 275 § 9.
17 As cited by *Banner*, Anglo-American Securities Regulation – Cultural and Political Roots: 1690–1860, 1998, p. 161.
18 As cited by *Banner* (N.17), p. 161.
19 See, *e.g.*, *Loss/Cowett*, Blue Sky Law, 1958, pp. 3–6.
20 Nev.Stat. 1909, Chapter 56.
21 *Mulvey*, Blue Sky Law, 36 Can.L.Times 33, 37 (1916).
22 Kan. L. 1911, Chapter 133, § 5.
23 *Loss/Seligman* (N.10), p. 7.

with the regulatory authority.[24] Following the new legislative trend, almost all States quickly followed suit by enacting their own State regulations, usually called "blue-sky laws",[25] taking one form or another,[26] with Delaware being the last State to enact its own blue sky law, with just one paragraph, in 1933.[27] In three blue sky rulings in 1917, the U.S. Supreme Court held that, in principle, these statutes were compatible with the U.S. Constitution.[28]

2. *New Deal Legislation and the Triumph of the Disclosure Philosophy*

The stock market crash of 1929 led to the establishment of disclosure obligations at the federal level and to the triumph of the disclosure philosophy. Because of the losses that investors had incurred as a result of the stock market crash, legislators could not remain inactive. The market value of all shares traded on the New York Stock Exchange (NYSE) had fallen from 89 billion Dollars in September 1929 to 13 billion Dollars in 1932. By 1939, Americans had lost 93 billion Dollars of capital in the market as a whole.[29] The massive stock exchange losses and the resulting bankruptcy of numerous banks had deeply shaken investors' trust in the financial system and they had ultimately called into question the very ability of the American mass-capitalist system as such to survive.[30] And when, in 1933, the Pecora Committee, a Congressional investigative committee, discovered large-scale rigging in the issuance and trading of shares, in which even the leading Wall Street finance houses were implicated, investors' confidence in the capital markets finally reached its lowest point.[31]

But it is worth noting that as early as 1928, *i.e.*, before the stock market crash, federal lawmakers, thanks in no small part to the impact of a broad wave of law reform in major European countries, including France (1929) and Germany (1931), had begun preliminary works on federal legal measures to deal with the capital market.[32] The question of what the "right" federal regulations should look like was, however, hotly debated. In addition to the possibility of introducing repressive measures, such as penal norms or governmental trading restrictions, and the continued pursuance of the blue-sky-laws approach by introducing content assessments based on substantive criteria for

24 *Loss/Seligman* (N.10), p. 7.
25 For details of the blue-sky-law concept, see *Loss/Cowett* (N.19), p. 3.
26 *Loss/Cowett* (N.19), p. 3.
27 Del. Laws 1931, Chapter 260; Del.Rev.Code § 4369 (1935).
28 Hall v. Geiger Jones, 242 U.S. 539 (1917); Caldwell v. Sioux Falls Stock Yards Co, 242 U.S. 559 (1917); Merrick v. N.W. Halsey & Co., 242 U.S. 568 (1917).
29 *Führhoff*, Kapitalmarktrechtliche Ad-hoc Publizität zur Vermeidung von Insiderdelikten, 2000, p. 26.
30 *Metzger*, US-Börsen: Beiträge zur Theorie der Finanzmärkte, 1994, p. 2.
31 *Metzger* (N.30), p. 2.
32 This process had been started by a Joint Resolution of Congress in 1928; *cf. Loss/Seligman*, Securities Regulation, 3d ed. 1998, pp. 228–230.

issuance applications on which governmental decisions would be made regarding the quality of securities, a third option was discussed: the introduction of statutory disclosure obligations which trusted the judgment of well-informed, responsible investors.[33] The latter alternative, known as "the disclosure philosophy", was modeled on English disclosure laws, *i. e.*, the Companies Acts of 1907 and 1929, was eventually implemented.[34] Two statutes were enacted. The first statute, the Securities Act of 1933, deals with the registration and issuance of certain securities. The registration is coupled with first-time object-related prospectus disclosure (*i. e.*, primary market disclosure) to ensure full and fair disclosure for (potential) buyers.[35] In contrast, the Securities Exchange Act of 1934 requires certain companies to provide on-going subject-related reports and disclosure about themselves. Accordingly, the 1934 Act affects the secondary market and secondary market disclosure.[36] Along with the introduction of disclosure requirements, a federal authority, the Securities and Exchange Commission (SEC), was established to assume responsibility for supervising the capital market, for overseeing compliance with both securities statutes, and for the promulgation of securities rules and regulations.[37]

The disclosure principle has since been developed further in both Acts, and disclosure obligations have been constantly expanded. Moreover, further provisions amending disclosure obligations have been added, or they have been developed on a case-by-case basis by the courts. For instance, anti-fraud provisions the scope of which has been considerably expanded by case law, are intended to ensure that investors are not deceived and defrauded even in the absence of explicit disclosure obligations.[38] Moreover, the application of disclosure obligations increasingly emphasizes what was originally only a secondary purpose, to present a deterrent to those obliged to disclose information, rather than its original purpose, which was to ensure the provision of information. The prohibition of insider trading by Rule 10b-5 is a clear illustration of this development: The imperative "to disclose insider knowledge or abstain" in order to avoid fraudulent trading is, in effect, simply a ban on insider trading – in other words, the disclosure obligation has the effect of a ban.[39]

The development of the classic disclosure philosophy, that is, the introduction of material obligations relating to conduct via disclosure obligations, is also reflected in the Sarbanes-Oxley Act of 2002. By enacting the Act, Congress reacted to the company scandals, involving Enron Corp., Tyco Interna-

33 *Seligman*, The Historical Need for a Mandatory Corporate Disclosure System, 9 J.Corp.L. 1, 39–41 (1983).
34 *Merkt* (N.12), p. 118.
35 See infra IV. 2. a).
36 See infra IV. 2. b).
37 See infra IV. 3. a).
38 See, *e.g.*, Section 10(b) of the 1934 Act und Rule 10b-5.
39 *Merkt* (N.12), p. 119.

tional Ltd. and WorldCom Inc., by reconfiguring corporate governance as these company crises could not be attributed to market-related, legal or financial risks but were simply consequences of corporate mismanagement.[40] The far-reaching statutory measures introduced by the Sarbanes-Oxley Act were intended to regulate conduct more effectively and to restore investor confidence by expanding disclosure obligations.[41]

It remains to be seen how the current financial market crisis will affect disclosure obligations in the U.S. and elsewhere. Nevertheless, one can see that disclosure has been used both broadly and in a targeted way to manage crises in the past, which leads one to suppose that the current financial crisis will also lead to more disclosure obligations.

III. Ensuring Investor Protection as a Function of Disclosure Obligations

By analyzing the goals of the various disclosure obligations,[42] one can establish that protecting individual investors is a primary purpose of disclosure obligations, both in Europe and in the U.S. The general economic benefits of the right allocation of free capital, thanks to the transparency of the market, and the fact that the capital market's functionality is assured, are mentioned along with investor protection.[43] Disclosure obligations have a protective effect with regard to both investors' own decisions (investors make their own judgments on the basis of as comprehensive a set of information as possible) and external decisions as it is guaranteed that market prices include all relevant information and have not been falsified or excluded.[44] This will be discussed in more detail below. Essentially, the possibility of investors' making investments that serve their best interests increases if they have access to more information about potential investment objects.[45] "Making an investment which serves the investor's best interests" is generally understood to mean "choosing the investment which provides the greatest financial advantage for a given risk level and which, therefore, maximizes the expected benefit for the investor".[46]

40 *Jutzi*, Verwaltungsratsausschüsse im schweizerischem Aktienrecht – unter besonderer Berücksichtigung der Verhältnisse in den USA, Deutschland und England, 2008, p. 133.

41 *Coffee/Seligman*, Securities Regulation – Cases and Materials: Supplement, 9th ed. 2003, pp. 1–5.

42 See the representation of the various disclosure infra VI.

43 See, *e.g.*, *Jutzi*, Die Offenlegung von Management-Transaktionen – Stand der schweizerischen Regelung im internationalen Kontext, Jusletter 1, 17 (March 17, 2008).

44 *Wüstemann*, Disclosure Regimes and Corporate Governance, 159 J. Inst. & Theor. Econ. 717, 720 (2003).

45 *Christensen/Demski*, Accounting Theory: An Information Content Perspective, 2003, p. 107.

Disclosure is intended to help investors to select the investment opportunity with the highest yield at the time and, hence, to make the "right" investment in economic terms. In other words, investors are meant to use the information available to them (in the case of non-privileged investors, this will be publicly available information) firstly to identify share investment options with the right company values, in their view, and then to calculate the fair value of the shares.[47]

Obviously, however, the assumption that people are fully rational does not correspond to reality; it can be proven empirically that individuals' decision-making behavior is, as a general rule, not substantially rational.[48] Hence, the notion that investor protection is ensured by direct information processing is not wholly convincing. It should, however, be noted that investor protection is a vague concept and is used to mean two things. Investor protection can mean the protection of the interests of individual investors in the sense described above, but investor protection can also have a far broader meaning beyond the individual sense, referring to investment protection as part of a capital market which functions with integrity.[49] The greatest importance is attached to investor protection beyond the individual sense because, ultimately, investor protection, properly understood, encapsulates the goal of the "right" capital allocation and of a capital market which functions with integrity. Investor protection beyond the individual sense assumes that all available information will be reflected accurately at all times in company share prices in an efficient capital market. In other words, it is assumed that a company's share price will always correspond to expected future payment flows from the company to its shareholders, with an appropriate discount factor for the existing risk level, and that new information about value determinants will lead to a prompt and accurate change in stock market value (this theoretical concept is known as Efficient Capital Market Hypothesis – ECMH).[50] This effect is guaranteed even if only a few investors (*e.g.*, perhaps institutional investors) who can influence prices have knowledge of the relevant information and process it correctly. If all publicly available information affects stock market prices immediately, it is not necessary for every single investor (who cannot influence prices) to obtain and evaluate information individually. Capital market participants

46 *Beaver*, Financial Reporting: An Accounting Revolution, 1997, p. 20.

47 *Ballwieser*, Aktuelle Fragen der Unternehmensbewertung in Deutschland, 76 ST 745, 748–750 (2002).

48 See, e.g., *Simon*, Administrative Behavior, 2d ed. 1970, p. 24. See also *Fox*, The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street, 2009.

49 *Watrin*, Internationale Rechnungslegung und Regulierungstheorie, 2001, p. 54.

50 *Fama*, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin. 383, 383–385 (1970).

can rely on stock market prices always to provide the best estimate of share values, in the light of the attendant risks.[51]

Nevertheless, in order to guarantee investor protection both in and beyond the individual sense, the asymmetry of the levels of information available to investors and issuers, as well as financial intermediaries, must be corrected, just as the conflict of interests between the two sides must be resolved.[52] The transparency created by disclosure obligations is central to this aim as transparency corrects the asymmetry of information.[53] Transparency also ensures that the capital market is fair, as it preemptively curbs fraud and deception. Potential investors will only have confidence, and invest their capital, in a fair and transparent market; if they feel that they are being misled, they will turn away from the capital market and invest their capital elsewhere or choose a different form of investment.[54]

Consequently, the U.S. disclosure philosophy assumes, essentially, that more disclosure obligations will necessarily lead to greater transparency, better investor protection, and greater confidence in the market. In this context, Justice *Louis Brandeis* has been quoted again and again. In his book "Other People's Money and How the Bankers Use it", which was published in 1913, he commented in metaphorical terms on disclosure: "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light is the most efficient policeman."[55] This does not, however, answer the question of what level of disclosure is appropriate, when the costs of disclosure outweigh its benefits, or when, if at all, disclosure has a negative effect if, for example, it cannot be absorbed or leads to a false sense of security. This is why, over the last four decades, there have been intense academic discussions about the advantages and disadvantages of disclosure obligations. These discussions, however, go far beyond the ambit of the present article.[56] For purposes of this study, it is sufficient to note that many economists are, admittedly, skeptical as to whether any static evidence can be produced to support the positive effects of disclosure obligations, but that they also assume, on the basis of the (semi-strong) ECMH which has been supported by empirical evidence,[57] that the market cannot produce sufficient information on its own and that, therefore, governmental disclosure obligations are entirely appropriate.[58]

51 *Watrin* (N.49), p. 54.

52 *Baker/Rapaccioli/Solomon*, United States of America Individual Accounts (*Ordelheide/KPMG* eds. 1995), p. 2993.

53 See *Jutzi* (N.43), p. 24.

54 *Watrin* (N.49), p. 54.

55 *Brandeis*, Other People's Money, 1913, p. 196.

56 For an overview of the discussion, see *Meier-Schatz*, Disclosure Rules in the U.S., Germany and Switzerland, 34 Am.J.Comp.L. 271, 284–285 (1986).

57 See, *e.g.*, *Fama* (N.50), p. 409. As early as 1978, the economist *Michael Jensen* maintained that there was no other economic model with as solid a foundation as the ECMH. See *Jensen*, Some Anomalous Evidence Regarding Market Efficiency, 6 JoFE 95, 95 (1978).

IV. Legal Principles of Disclosure Obligations

1. Federal and State Regulations

a) Disclosure Obligations in Corporate Law

Unlike many European countries, such as Switzerland, Germany and France, where many disclosure obligations for corporations are founded in corporate law, disclosure obligations in the U.S. are derived not primarily from corporate law but mostly from capital market law. Thus, in the U.S., there is no comprehensive financial disclosure obligation in corporation law for all corporations.[59] This fact is related to the way in which legislative authority is allocated in the U.S. In the U.S., the States have jurisdiction to regulate corporations and enact corporate law statutes. However, compared to many European countries, States in the U.S. have introduced only rudimentary disclosure regulations.[60] A commercial or company register in which the proceedings after a company's foundation would have to be recorded in detail is unknown in most States.[61] Moreover, in most States, corporate law does not provide for general external disclosure of financial accounting information. As a general rule, only shareholders have a right to inspect their corporation's financial statements.[62] Hence, corporate law disclosure obligations for corporate entities that are not subject to the federal securities laws play a rather insignificant role. It should be noted, however, that – at least in certain cases concerning Delaware corporations[63] – courts have derived a duty to disclose from the duty of loyalty and the duty of good faith existing under State law. It has

58 See, *e.g.*, *Coffee*, Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va. L. Rev. 717, 743–745 (1984); *Easterbrook/Fischel*, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 699–703 (1984).

59 *Watrin* (N.49), p. 54. For a more detailed exposition of this view, see *Siegel*, Financial Disclosure and Transparency: A U.S. American Perspective, in: *Ebke/Möhlenkamp* (eds.), Rechnungslegung, Publizität und Wettbewerb, 2009, pp. 39 et seq.

60 *Merkt* (N.12), p. 183; see also *Siegel*, Accounting for Non-Listed Companies Under United States Laws, Regulations, Accounting and Auditing Standards, in: Ebke/Luttermann/Siegel (eds.), Internationale Rechnungslegungsstandards für börsenunabhängige Unternehmen?, 2007, pp. 95, 96–98.

61 *Watrin* (N.49), p. 54.

62 Nevertheless, according to the law of California, companies with 100 or more shareholders and no financial accounting disclosure obligations under federal securities laws are required to send their shareholders an annual report produced in accordance with generally recognized accounting principles. *Cf.* Sec. 1501 Cal.Corp.-Code.

63 See, *e.g.*, Lynch v. Vickers Energy Corp 383 A.2d 278 (Del. 1977); Malone v. Brincat 722 A.2d 5 (Del. 1998).

become "well-established that the duty of disclosure represents nothing more than the well-recognized proposition that directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action".[64] In *Malone* v. *Brincat*, the Court held that even in the absence of a request for shareholder action "directors who knowingly disseminate false information that results in corporate injury or damage to an individual stockholder violate their fiduciary duty, and may be held accountable in a manner appropriate to the circumstances".[65] It is worth noting that, in a lawsuit alleging breach of the duty of loyalty and the duty of good faith, "the essential inquiry in such an action is whether the alleged omission or misrepresentation is material".[66]

b) Disclosure Obligations in Capital Market Law

For the purposes of the present article, State capital market regulations (*i. e.*, State blue sky laws) are not taken into account because, in many cases, they focus not on financial disclosure and transparency, but primarily on the monitoring of issuance content by State authorities ("merit regulation"). Also, because they contain rules similar to or identical with federal securities laws, State blue sky laws are often preempted by federal securities regulation.[67] By contrast, financial disclosure plays a central role as a regulatory instrument in federal capital market law.[68] The federal government has legislative authority over interstate capital market transactions because of the Interstate Commerce Clause of the U.S. Constitution.[69] According to the 1933 Act, to be subject to federal legislation it is sufficient to "[make] use of any means or instrumentality of interstate commerce or the mails"[70] in connection with the purchase or sale of a security.[71] Moreover, the provisions of the 1934 Act are applicable whenever the issuer carries out any kind of interstate commercial transaction.[72] One should also notice that both the concept of a security and that of a publicly-held company are understood in significantly broader terms in the U.S. than in many European legal systems, which means that the scope of federal securities regulation is far greater than in many European countries.[73] This could ultimately be explained by the fact that, despite its lack of power as to the making of corporate law, federal legislation can still create standards for corporations and thereby ensure that shareholders receive a level of protection that State corporation laws are not willing to provide.[74]

64 Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998).
65 Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998).
66 Malone v. Brincat, 722 A.2d 5, 12 (Del. 1998).
67 If the conclusion of the merit analysis is that issuance conditions are not "fair, just, and equitable", issuance can be prohibited. See *Hazen*, The Law of Securities Regulation, 5th ed. 2005, § 9. 7.
68 See supra II. 2.
69 Article I, Section 8, Clause 3 of the U.S.Constitution.
70 Section 10(b) of the 1934 Act.
71 Nevertheless, there are numerous extenuating circumstances regarding transactions. Small companies and private placements are generally exempt from the obligation to register. See, *e.g.*, *Loss/Seligman* (N.10) pp. 359, 378–383.
72 Section 3(a)(17) of the 1934 Act.

2. *The Cornerstones of U.S. Capital Market Law*

U.S. capital market and securities law (securities regulations) comprises a large number of statutes enacted at both Federal and State level. In addition, there are many rules and regulations that are based on those statutes.[75] The cornerstones of U.S. capital market law are the Securities Act of 1933 and the Securities Exchange Act of 1934.[76] Both statutes were enacted in response to the stock market collapse of 1929 and the ensuing Great Depression. They were part of President *Franklin D. Roosevelt's* New Deal to protect investors and to preserve the integrity of the securities markets.[77] The Sarbanes-Oxley Act which was introduced in 2002 and which regulates, *inter alia*, disclosure obligations for U.S. corporations can be listed as the third cornerstone.[78]

a) Securities Act of 1933

The Securities Act of 1933 was the first significant federal statute to regulate the offer and sale of securities. Before then, the securities trade had largely been regulated by scattered State laws.[79] The Securities Act regulates the primary market, *i. e.*, initial sales of securities, known as initial public offerings.[80]

73 A company becomes a "reporting company" and must file periodic report under § 13 of the 1934 Act if (i) it lists its securities on a national securities exchange (§ 12[b]); if (ii) any class of its equity securities is held of record by at least 500 persons and the corporation has gross assets over a specified level (currently $ 10,000,000) (§ 12(g)); or if (iii) the corporation files a 1933 Act registration statement that becomes effective (§ 15(d)). The concept of the "security", as defined in § 2(a)(1) of the 1934 Act and in § 3(a)(10) of the 1933 Act, is interpreted broadly by U.S. courts. According to the *Howey* test, an investment contract for the purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. See SEC v. W. J. Howey Co., 328 U.S. 293 (1946).
74 *Merkt* (N.12), p. 298.
75 See supra IV.1 and infra VI.
76 *Pellens/Fülbier/Gassen/Sellhorn*, Internationale Rechnungslegung, 7th ed. 2008, p. 849.
77 See supra II. 2.
78 See infra IV. 2. c).
79 See supra IV. 1. b).
80 *Baker/Rapacciol/Solomon* (N.52), pp. 2993–2995.

The Securities Act stipulates that investors must receive material information about the securities being offered for sale in order to prevent fraud, deception and other kinds of abuse.[81] The preamble to the Securities Act states that the Act serves "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes".[82] Hence, it is mandatory for the issuing company's securities to be registered with the SEC. For this registration, each company is required to submit a registration statement providing detailed information about both the company and the planned issuance.[83] Some of the information contained in this document, including the balance sheet and the profit and loss statement, must be distributed in a prospectus to potential investors. The information[84] contained in the prospectus can be examined at the SEC.[85] The disclosure provisions of the 1933 Act are amended by SEC Rules and Regulations. In particular, forms are provided for specific basic share issuance situations.[86] The Rules and Regulations of the SEC require a description of the securities being offered for sale, information about the issuer's management and further information about the securities if the securities are not ordinary shares and the financial information in question is not required to be confirmed by an independent auditor.[87] Further details of the disclosure obligations under the Securities Act of 1933 will be provided in Section – below ("Registration Transparency"). The two most important aspects of the Securities Act's regulation of the sale of securities are as follows: Firstly, primary sales have to be registered with the SEC; secondly, buyers must be provided with a great deal of information contained in prospectus form in the registration application.[88] The Securities Act is based on the assumption that the truth about securities needs to be disclosed at the time of their issuance and that it is then for the investor to assess the published information.[89] A breach of the obligation to tell the truth is subject to civil and criminal liability.

81 *Ratner*, Securities Regulation, 6th ed. 1998, p. 33.
82 See *MacLaughlin/Hambleton*, Securities and Exchange Commission Reporting Requirements, Accountant's Handbook, vol. I: Financial Accounting and General Topics, 2007, Chap. 3. 20.
83 *Watrin* (N.49), p. 54.
84 Schedule A (24) of 1933 Act.
85 *Ratner* (N.81), p. 34.
86 See infra IV. 3. b).bb).
87 See *Soderquist/Gabaldon*, Securities Law, 2004, p. 64.
88 *Carmichael/Whittington/Graham/Rosenfield*, Accountants' Handbook, vol. II, 11th ed. 2007, Set 3.20. Moreover, buyers who suffer losses within a specific period of time are permitted to recover their losses if the registration application contained a materially misleading statement.
89 *Ratner* (N.81), p. 33.

b) Securities Exchange Act of 1934

The scope of the Securities Act is limited, however, as it does not cover the most frequent form of the trade in securities, *i. e.*, the sale of issued and outstanding securities.[90] Whether carried out on a stock exchange, "over the counter" (OTC) or in any other way, these transactions are, essentially, regulated by the Securities Exchange Act of 1934.[91] Hence, the Securities Exchange Act and Rules promulgated thereunder by the SEC regulate the secondary market, *i.e.*, the trade in securities which have already been issued.[92] Even for these securities to be approved for trading, the company concerned must first be registered. The comprehensive information required for this registration is similar to that required by the 1933 Act and also includes balance sheets[93] and profit and loss statement[94] for the last three fiscal years.[95] The subsequent periodic reporting obligations are annual financial statements (Form 10-K), a Quarterly Report (Form 10-Q), and a current report for extraordinary circumstances (Form 8-K).[96] In addition to the reporting obligations just mentioned, the 1934 Act contains two other important provisions: Sections 10(b) and 18(a).[97] Section 10(b) and Rule 10b-5 that was promulgated by the SEC provide for liability for misinformation relating to the purchase or sale of securities;[98] liability for false information in proxy statements is subject to liability under Section 18(a).[99] Details on the disclosure obligations under the Securities Exchange Act of 1934 will be provided in the Sections VI.2 to VI. 7.

c) Sarbanes-Oxley Act

The Sarbanes-Oxley Act of 2002 is another federal statute that regulates the disclosure obligations of U.S. corporations. The Act was enacted as a direct legislative response to the Enron, Tyco and WorldCom accounting scandals that caused the greatest slump in the capital market since the 1929 stock market collapse.[100] The Sarbanes-Oxley Act alterations numerous fundamental

90 Billions of US dollars are gained and lost in trade on the secondary market. See *Carmichael/Whittington/Graham/Rosenfield* (N.88), p. 3.21.
91 See *Carmichael/Whittington/Graham/Rosenfield* (N.88), p. 3. 20.
92 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 849.
93 Section 12 (b)(1)(J) of the 1934 Act.
94 Section 12 (b)(1)(K) of the 1934 Act.
95 *Watrin* (N.49), p. 55.
96 See infra VI. 2. a), VI.3 and VI. 4. a).
97 See infra VI. 2. a).
98 Because of the comprehensive authority of Rule 10b-5, the U.S. Supreme Court described it as "catch-all" in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976).
99 See infra VI. 2. d).
100 *Cheffins/Thomas*, Should Shareholders Have a Greater Say over Executive Pay?: Learning from the U.S. Experience, 1 J. Corp. L. Stud. 277, 299 (2001). Enron, in particular, used a system of rigging and deception to inflate sales and show profits which were not actually there. Thus the period from 1997 to 2001 showed total

provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. The purpose of the Sarbanes-Oxley Act is to protect investors by improving the accuracy and reliability of company reports.[101] The Act targets the two spheres thought to have the greatest influence on the accuracy and reliability of financial reporting. Firstly, it aims at making a company's accounting system more transparent and effective through reporting and assessments by an internal control system and through more a comprehensive supervision by an audit committee.[102] Secondly, the Act's objective is to make the corporation's auditor more effective as an external supervisory authority by requiring the auditor to be independent of the audited corporation and by limiting the self-regulation of the accounting profession.[103] The new provisions are mandatory for all companies required to register according to Section 12(g) of the Securities Exchange Act.[104] One notable aspect of the Sarbanes-Oxley Act is that it is the first U.S. federal law specifically affecting corporate governance the regulation of which, in principle, is entrusted to corporate law at State level.[105] Moreover, through the Sarbanes-Oxley Act, a new supervisory board was created, *i.e.*, the Public Company Accounting Oversight Board (PCAOB). The Board's primary task is the supervision of auditors, and it has the authority to develop and implement financial accounting principles.[106] In the context of this article, the newly introduced disclosure controls and procedures are particularly significant, as is extended financial reporting. According to Section 302 of the Sarbanes-Oxley Act, a company's board of directors is obliged to establish controls and procedures that ensure accurate disclosure of financial information (*i.e.*, disclosure controls and procedures). The chairman of the board and the chief financial officer are also obligated to provide an assurance under oath that the financial information submitted to the SEC is cor-

profits of approximately 586 million US dollars which had no basis in reality. Moreover, documents which proved this false accounting and which therefore constituted evidence of fraudulent activity were destroyed. As a consequence of this accounting scandal, Enron eventually had to file for bankruptcy protection. The share price fell from a high of more than 100 US dollars to a low of 0.67 US dollars. In 2002, Enron shares were excluded from the market. Because of this catastrophic destruction of capital, in which the company's managers and accounting firm were implicated, investor confidence was shattered for a long time. In their high spirits and expectations of substantial profits, Enron investors had lost almost everything they had invested. See *Menzies*, Sarbanes-Oxley Act: Leitfaden für die Praxis, Grundlagen, Methoden, Projektberichte, 2004, p. 8.

101 *Coffee/Seligman* (N.41), pp. 1–5.

102 *Hazen* (N.67), § 9.7.

103 *Alves*, Reporting nach US-GAAP – Ein Überblick, 2007, p. 16.

104 This applies if the company is listed on a national (U.S.) stock exchange, or if it has at least 500 shareholders and its assets at the end of the last fiscal year amounted to at least 10 million US dollars.

105 *Hazen* (N.67), § 9.7.

106 *Alves* (N.103), p. 16.

rect, and to confirm that they have fully examined their disclosure controls and procedures.[107] Foreign companies must fulfill this obligation once a year as part of their annual statements, while U.S. companies must include a confirmation under oath in every Quarterly Report throughout the year.[108]

Furthermore, the Sarbanes-Oxley Act expands financial reporting requirements: The fourth Title of the Act includes stipulations for disclosing off-balance-sheet business transactions, the general ban on loans to members of the board of directors and the supervisory board, and shorter deadlines for reporting share transactions involving members of the executive body or major shareholders.[109] The fourth Title also contains the central norm of the Sarbanes-Oxley Act, Section 404, according to which a company's management must confirm the effectiveness of the company's internal control system (ICS) and submit both its assessment and the ICS to an examination by the independent external auditor. The significance of this examination can be inferred from the fact that the result forms part of the independent external auditor's report.[110] Section 406 of the Sarbanes-Oxley Act requires the establishment of a code of conduct for senior finance employees which must go beyond the existing code of conduct for managers and focus specifically on financial reporting. According to Section 407, it must also be disclosed whether at least one of the members of the audit committee is a financial expert as required by the SEC's performance conditions and, if not, a reason for the absence of such a financial expert must be given.[111]

3. *Enforcement of Information Obligations by the SEC*

a) The Powers of the SEC

Founded in 1934, the SEC is an independent regulatory agency with extensive executive, legislative and judicial powers to carry out its tasks, making it one of the most powerful federal authorities in the U.S.[112] The SEC is entrusted with the task of administering, implementing and enforcing the federal capital market statutes.[113] The SEC's aim is to establish and maintain the flow

107 *Menzies* (N.100), p. 40.

108 *Menzies* (N.100), p 40.

109 Here, Section 403 of the Sarbanes-Oxlex Act sets a capital share limit of 10 %; any person exceeding this limit counts as a major shareholder.

110 *Merkl*, Neue Vorschriften der SEC und des PCAOB zum IKS, Änderungen bei der Umsetzung von Art. 404 des SOX, 12 ST 38, 38–39 (2007).

111 The SEC defines an "audit committee financial expert" as a person with knowledge of annual financial statements and accounting standards, and of the way in which they could be expected to apply to the company concerned, and who understands internal financial reporting controls and the tasks of the audit committee. See SEC-Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence, Release No. 33-8183, II.A. 4. a.

112 *Hazen* (N.67), § 1.3.

113 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 58.

of information from companies to the public and, thus, to create fair, organized and efficient capital market conditions.[114] The SEC is the central authority for implementing the disclosure philosophy.[115]

At the executive level, the SEC has the task of administering the federal securities laws. In this context, the SEC is responsible for approving securities, both of companies and of securities traders, for the capital market, and for registering these securities. The SEC must also supervise compliance with the regulations of the U.S. capital market.[116] Hence, the SEC is responsible for dealing with registration applications, and it is the federal agency with which company reports are to be filed.[117] When registering securities, the SEC formally, rather than substantively, examines the information provided by the company in order to determine whether and to what extent the information provided is complete and appropriate.[118] To perform its tasks, the SEC also has the authority "to adopt whatever rules and regulations may be necessary".[119] Therefore, the SEC's legislative tasks include the promulgation of Rules and Regulations and the issuance of Orders, within the limits of its authority, for the implementation of the federal securities laws concerning the trade in securities.[120] In addition, the SEC has the power to establish principles concerning both the substance and form of financial statements of companies subject to the federal securities laws. However, the SEC has entrusted the development of financial accounting principles to the Financial Accounting Standards Board (FSAB), thus passing on its responsibility for a core area of information to a private body.[121] Nevertheless, the SEC has expressly reserved its right to change or amend principles developed and adopted by the FASB even though they have, in principle, the SEC's "substantial support".[122] Furthermore, the SEC not only has the task of supervising compliance by companies of their disclosure obligations under federal securities laws, but it is also required to enforce these obligations. The SEC can adopt a wide range of measures to compel companies to comply with registration, reporting and

114 SEC, Annual Performance Report, 2001, p. 73.

115 *Skousen*, An Introduction to the SEC, 5th ed. 2001, p. 7.

116 *von Kirchbach* (N.3), p. 5.

117 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 59.

118 The SEC does not, however, supervise the standard or quality of security prices. This judgment is left entirely to market participants. Hence, it is a necessary condition that market participants receive the necessary information about the securities issued. See infraVI. 1.

119 *Loss/Seligman* (N.10), p. 152.

120 Both the 1933 Act and the 1934 Act are very abstract and general. For instance, capital market oriented companies are under an obligation to provide regular annual and quarterly statements. Yet, neither the 1933 Act nor the 1934 Act contains any substantial regulations concerning the material or formal content of such accounts. *Cf. Pellens/Fülbier/Gassen/Sellhorn* (N.76), p 59.

121 *Baker/Rapaccioli/Solomon* (N.52), p. 2993.

122 *Loss/Seligman* (N.10), p. 191.

other obligations and to impose penalties if these obligations are breached. At the judicial level, the SEC has extensive decision-making powers in civil, administrative and criminal law, and it can carry out investigations and bring prosecutions independently. The SEC has direct authority also to impose administrative penalties.[123]

Obviously, the SEC is of paramount importance for the implementation and enforcement of information obligations under the federal securities laws. The SEC also stands for the proposition that the protection of investors can be ensured primarily by means of information.[124] Thus, the SEC's motto reads: "Disclosure, again disclosure and still more disclosure."[125] But the nature of its tasks also reveals the SEC's inadequate separation of powers: The SEC "may make laws, may act as a public prosecutor in enforcing these laws, and may then determine the guilt or innocence of the person it has accused".[126]

b) SEC Instruments to Ensure the Application of the Disclosure Philosophy

The SEC's official statements, including the documents submitted by registered companies, have been available for years to the public in the Public Reference Room in the SEC offices in Washington, D.C.

aa) EDGAR

Since 1993, the SEC has also been offering a special electronic service since 1993. The SEC's electronic database, the Electronic Data Gathering, Analysis and Retrieval System (EDGAR), automatically collects, checks and publishes computerized electronic forms.[127] Reports reviewed by the SEC and SEC Rulings are also published and provided free of charge to all Internet users.[128] This enables even small investors to access the electronic archive at any time. Thus, the purpose of the Edgar database is to increase the efficiency and fairness of the capital market by expediting the publication of time-sensitive information.[129]

123 See *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 59.

124 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 850.

125 *Loss/Seligman* (N.10), p. 7.

126 *Lang/Lipton*, The Securities Enforcement Manual: Litigation Administrative Proceedings – The SEC's Increasingly Important Enforcement Alternative, 1997, pp. 239, 242.

127 The Edgar database can be viewed at http://www.sec.gov/edgar.shtml. But there are also unofficial, user-friendly Edgar sites; for example, 10k Wizard at http://www.10kwizard.com/or Edgar Online at http://www.edgar-online.com/.

128 SEC, Electronic Filing and the EDGAR System: A Regulatory Overview (October 2006).

129 *von Kirchbach* (N.3), p. 11.

bb) Set of Regulations

(1) Regulations and Rules

As already mentioned, the SEC is authorized to enact Rules and Regulations.[130] Essentially, the SEC has used its authority to create formal requirements for the annual financial statements that must be submitted.[131] The most important Regulations promulgated by the SEC are:

- Regulation S-X concerning the general structure and content of financial statements which must be submitted to the SEC,
- Regulation S-K concerning the publication of additional information and
- Regulation S-T concerning the requirements for the electronic submission of statements.[132]

Regulation S-X and Regulation S-K are of central importance for the disclosure by issuers. Regulation S-X deals with information of a financial nature, specifically the form and content of the required financial statements,[133] whereas Regulation S-K deals with narrative information.[134] The information obligations under Regulation S-X include "financial statements" which must be prepared in accordance with Generally Accepted Accounting Principles (GAAP). In addition, General Notes to Financial Statements[135] are required of companies within the ambit of the federal securities laws. The information required by Regulation S-K ranges from the company's purpose, sector developments,[136] ownership[137] and ongoing legal disputes[138] to a detailed breakdown of compensation of the management.[139] Item 303 of Regulation S-K dealing with the Management's Discussion and Analysis of Financial Condition and Results of Operations,[140] is especially noteworthy because it either requires or encourages, as the case may be, publication of future-oriented information.[141]

130 See supra IV. 3. b).bb).
131 *Alves* (N.103), p. 14.
132 *Alves* (N.103), p. 15.
133 Rule 1-01 (a) of Regulation S-X.
134 Item 10 (a) of Regulation S-K.
135 Rule 4-08 of Regulation S-X. The "general notes to financial statements" include additional information requirements concerning assets, income taxes, pension deals and derivative financial instruments, as well as a description of circumstances which could possibly reduce dividend payments.
136 Item 101 (a), (b), (c) of Regulation S-K.
137 Item 102 of Regulation S-K.
138 Item 103 of Regulation S-K.
139 Item 402 of Regulation S-K.
140 Item 303 of Regulation S-K.
141 See infra VI. 2. a).bb).

(2) Forms

In addition to the general information required by the SEC's Rules and Regulations, companies within the ambit of the federal securities laws are required to provide financial information by using compulsory forms which specify the exact information that must be submitted. The most important forms are:[142]

- Form 10-K for annual financial statements of U.S. corporations,
- Form 10-Q for the quarterly financial statements of U.S. corporations,
- Form 8-K for ad hoc reporting.
- Form 20-F for the annual financial statements of foreign issuers.[143]

For almost every required publication, there is a specific form.[144] Registered companies must follow these forms strictly regarding both form and content for the purposes of information, disclosure and reporting.[145] It is also highly significant for the purposes of transparency that the SEC insists upon the use of comprehensible language. Hence, the information in the forms must be given in short sentences and simple words and constructions ("plain English") so that shareholders can understand it easily.[146]

(3) Staff interpretations

Another informal, though not legally binding, way of implementing federal securities laws can be summarized as "informal law-making" by the SEC. This informal law-making includes SEC Releases that comment on specific subjects or suggest interpretations of statutes and administrative Rules and Regulations.[147] There are also responses by SEC employees to actual enquiries about specific company transactions, called "no-action letters",[148] which can also be accessed by the general public.[149] No-action letters contain information on actual cases which are made public in response to private enquires by market participants. The SEC has pointed out, however, that one cannot necessarily infer the SEC's general position from its response to an enquiry concerning a specific situation as these situations can be highly fact sensitive.[150] The Staff Accounting Bulletins (SAB) published to implement Regulation S-X, are also worth mentioning in this context; SAB are interpretations of funda-

142 See infra VI.
143 *Alves* (N.103), p. 15.
144 All forms can be accessed at the SEC homepage, where they are listed in alphabetical and numerical order; see: http://www.sec.gov/about/forms/secforms.htm.
145 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 851.
146 *von Kirchbach* (N.3), p. 38.
147 *von Kirchbach* (N.3), p. 6.
148 The name, "no-action-letter", derives from the SEC's standard response to such enquiries, that "the staff will recommend no action to the Commission" if the transaction is carried out in the manner described. See *Ratner* (N.81), p. 16.
149 *Ratner* (N.81), p. 20.
150 *Hazen* (N.67), § 1.4(4).

mental questions or issues that have arisen from the examination of financial statements filed with the SEC.[151] While, legally, these interpretations are not binding, any deviation from their provisions needs to be justified.

cc) The SEC Integrated Disclosure System

The SEC ensures that there is a single, simple and consistent disclosure system which entails the requirements of the relevant statutes and in which shareholder communication is included in official reports for the attention of the SEC. Thus, there is no significant degree of repetition of the various registration and disclosure obligations according to primary market regulations and secondary market regulations, which are juxtaposed in a complex fashion both under the Securities Act and the Securities Exchange Act.[152] Hence, following the principles of the ECMH, the SEC attempts to ensure that relevant information is disclosed early, but only once because the ECMH suggests that, in a highly developed and sophisticated investment information market, professional analysts, investment advisers, information services and the economic and financial press will ensure that new information is processed quickly.[153] The SEC concludes from this that wherever professional information processors provide information to the public, it can limit its range of recipients to this target group without compromising effective disclosure.[154] Hence, all companies with reporting obligations under the federal securities laws are required to produce a basic information package in standardized form and content and submit it to the SEC in order to avoid the double registration of companies and to make disclosure obligations easier to supervise. This package can be extended or reduced, as needed. If further disclosure reports are submitted, it is possible to refer to the basic available data in subsequent forms. The basic information package thus forms the basis of the reports which must be submitted to the SEC, whether on a non-regular basis, as with issuance disclosure, or on a regular basis, as with mandatory annual and quarterly reports.[155] In addition, as part of the implementation of the integrated disclosure system, Rule 415 grants certain companies[156] the option of registering a security even if it will not be issued immediately.[157] This shelf registration gives companies greater time flexibility in placing their securities in the securities market.

151 *Alves* (N.103), p. 15.
152 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 850.
153 *Merkt* (N.12), p. 121.
154 Executive Summary of SA Release Nos. 6331–6338 (8. 6. 1991).
155 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 852.
156 Among others, these include companies entitled to use Form S-3. See below for more details VI. 1. c).
157 A "registration statement" submitted as a precautionary measure entitles the issuer to issue the relevant security within the following three years. Thereafter, the documents must be resubmitted. See SEC: Release-No. 33-8591; 34-52056; FR 44722 (Aug. 3, 2005): Securities offering reform, here p. 44775.

dd) Penalties

U.S. corporations can be compelled by the SEC to comply with the extensive and detailed disclosure obligations under the federal securities laws. If registration, reporting or other obligations are breached, the SEC can impose penalties. The SEC's measures can be both reactive and proactive, *i. e.*, the SEC examines selected reports either on its own initiative or in response to third party information.[158] Thus, it sends the signal that wrongdoing is likely to be exposed, which acts as a powerful deterrent. Above all, the SEC has decision-making powers for criminal law purposes. Infringements of disclosure obligations, especially the provision of false information in registration statements, are treated as fraud. Since the Enron scandal, the punishments for criminal violations have become significantly harsher.[159] Managers responsible are subject to fines and imprisonment. Violations of disclosure obligations, including the provision of false or misleading information, are also subject to civil liability under the federal securities laws. Under the 1933 Act, the issuer's management, the issuing bank, and the auditors, lawyers and other professionals may be held liable for the accuracy of the information in the prospectus. Investors are entitled to claim damages for losses resulting from untrue statements of fact, or the omission of material facts, in the registration statement.[160] The SEC is authorized to bring any relevant civil suits. In addition, Section 28(a) of the 1934 Act provides that the rights and remedies provided under this Act "shall be in addition to any and all other rights and remedies that may exist at law or in equity". Also, the SEC has the authority directly and independently to impose administrative penalties, including temporary or even permanent exclusion from the stock market. The SEC may also impose fines, issue reprimands or restrict the professional activity of securities traders and investment advisers; the SEC is even empowered to ban these individuals from their professions. The SEC is also authorized to institute disciplinary proceedings not only against individuals who are active in registered companies, but also against self-regulatory organizations, such as stock exchanges. It also has disciplinary powers against U.S. auditors – in fact, the SEC's control obligations include the supervision of auditors. This responsibility was allocated to it by the Sarbanes-Oxley Act with the creation of the Public Company Accounting Oversight Board (PCAOB).[161]

ee) The Role of the Courts as to Information Obligations

In addition to the SEC, federal courts in the U.S have made significant contributions to the interpretation and application of information obligations of corporations within the ambit of the federal securities laws. In view of the general

158 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 878.
159 *von Kirchbach* (N.3), p. 48.
160 See infra VI. 1.
161 *Cf. Pellens/Fülbier/Gassen/Sellhorn* (N.76), pp. 59–61.

vagueness or broadness of many disclosure norms, federal courts have clarified the meaning of these norms affecting issuers, their management and others. The relevant case law also deals with important Rules that were promulgated by the SEC, in particular Rule 10b-5 and Rule 14a-9.[162] In addition, courts have helped to understand and apply legal concepts such as the concept of materiality and have provided solutions for cases of omissions to state a material fact.[163] The combination of imprecise norms, far-reaching civil liability, and generous rules of civil procedure often favors investors and provides incentives for the private enforcement of norms. As a result, there is an abundance of relevant case law.[164] The large number of investor lawsuits that, essentially, are an important instrument for the implementation and enforcement of federal securities laws[165] was not, however, seen in an entirely positive light, as more and more claims were not at all justified; rather, an increasing number of lawsuits seeking damages were dishonest.[166] The vagueness of many norms and the possibility of initiating class actions were exploited by professional plaintiffs and specialist lawyers to lead defendants to pay damages or settled a case out of court.[167]

The Private Securities Litigation Reform Act of 1995 (PSLRA) was enacted to prevent this kind of abuse. Thus, for example, the Act requires that, to the extent possible, the main plaintiff in a class action be the one with the largest financial stake in the defendant company.[168] Moreover, the plaintiff needs to produce evidence that the norm violation by the defendant was deliberate.[169] Because the courts interpreted this condition in different ways, however, it did not result in any effective limitation of the number of securities lawsuits.[170] Therefore and in order to prevent circumvention of the PSLRA, which applied only at federal level, by resorting to State courts, the Securities Litigation Uniform Standards Act of 1998 (SLUSA) was enacted.[171] This Act requires that

162 See infra V. 1.

163 See infra V. 2.

164 See, *e.g.*, *Ratner* (N.81), p. 18.

165 *Wüstemann*, Institutionenökonomik und internationale Rechnungslegungsordnungen: Die Einheit der Gesellschaftswissenschaften, 2002, p. 143.

166 *Moos*, Pleading Around the Private Securities Litigation Reform Act: Reevaluating the Pleading Requirement for Market Manipulation claims, 78 So.Cal. L. Rev. 763, 763 (2005).

167 *Moos* (N.166), p. 764.

168 See Section 101 (a)(3)(B) PSLRA: Courts will select the "most adequate plaintiff"; there is a debatable suspicion that the latter is the plaintiff with the largest stake in the company.

169 Section 101 (b)(2) PSLRA.

170 *Moos* (N.166), p. 764.

171 *Moos* (N.166), p. 764.

class actions be heard by federal courts and that federal securities regulations be applied.[172]

4. *The Regulations of Self-regulatory Organizations*

Companies listed on the New York Stock Exchange (NYSE), the American Stock Exchange (ASE) or NASDAQ are subject to their regulations under private law; the stock exchanges and Nasdaq all have their own listing and disclosure standards. The disclosure standards are primarily concerned with the prompt disclosure of material information on a continuous basis,[173] *i.e.*, *ad hoc* disclosure.[174] The NYSE requires listed companies publicly to disclose all relevant news and information promptly; provided, the companies expects information significantly to influence the securities market.[175] The ASE also has a rule whereby listed companies are obligated immediately to disclose significant information concerning their business affairs.[176] And the NASDAQ Manual requires a listed company immediately to disclose, through the press, all significant information affecting the value of their securities.[177]

V. The Guiding Principle of Full and Fair Disclosure

1. *The Basic Principle of Full and Fair Disclosure*

Since the enactment of the federal securities regulations in the 1930s,[178] the basic principle of U.S. disclosure law has been the philosophy of full and fair disclosure.[179] The purpose of the enacted statutes was "to substitute a philosophy of full and fair disclosure for the philosophy of *caveat emptor* and, thus, to achieve a high standard of business ethics in the securities industry".[180]

172 *Patel*, Securities Regulation – Fraud-Rule 10b-5 No Longer Scares the Judiciary, But May Scare Corporate Defendants: The United States Supreme Court Switches Direction, 27 U. Ark. Little Rock L. Rev. 191, 209 (2005).

173 See infra VI. 3.

174 *Choper/Coffee/Gilson*, Case and Materials on Corporations, 7th ed. 2008, p. 306.

175 The following passage appears under the heading, "Timely Disclosure of Material News Developments of NYSE Listed Company Manual par. 202.05": "A listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities. This is one of the most important and fundamental purposes of the listing agreement which the company enters into with the Exchange."

176 AMEX Company Guide § 401: "A listed company is required to make immediate public disclosure of all material information concerning its affairs, except in unusual circumstances."

177 NASDAQ Manual, Schedule D, Part II § (B) (3) (b).

178 See supra II. 2.

179 *Loss/Seligman* (N.10), p. 38.

180 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) with reference to H. R. Rep. No. 85, 73rd Cong., 1st Sess. 2, quoted in Wilko v. Swan, 346

a) Full Disclosure

The phrase "full disclosure" does not, however, answer the question of what information needs to be published. As a starting point, one can infer what information must be provided from a combination of various disclosure norms[181] and the overall objective of fair presentation.[182] The required degree of insight into the company is also emphasized by disclosure obligations developed by judge-made law. Rule 10b-5 and Rule 14a-9 that, essentially, prohibit false and misleading statements, play a particularly significant role in this context.[183] Rule 10b-5 which was promulgated by the SEC under Section 10(b) of the 1934 Act prohibits anyone "(1) to employ any device, scheme, or artifice to defraud, (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading [...]"[184] when buying or selling securities. With regard to proxy statements, Rule 14a-9 stipulates that "[n]o solicitation [...] shall be made [...] containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading [...]".[185] Thus, Rule 10b-5 contains the U.S. American securities laws' basis proposition of the time-honored "disclose or abstain" rule. According to this rule, a person who has significant and undisclosed information about a company, either because of his or her position in the company or because of his or her professional activities, is under obligation either to disclose the inside information or to refrain from trading in the company's securities.[186] The scope of Rule 10b-5 has, however, been significantly extended by case law.[187] Disclosure obligations can exist under Rule 10b-5 independently of securities transactions; if a significant fact relating to the sale or purchase of a security has been communicated or omitted by an insider, such a case falls within the scope of the Rule if, in the opinion of the court, a disclosed information is apt to influence potential investors to carry

U.S. 427, 430. The U.S. Supreme Court has emphasized this many times since. See, *e.g.*, Basic Inc. v. Levinson, 485 U.S. 224 (1988); Affiliated Ute Citizens v. U.S., 406 U.S. 128, 151 (1972); Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 477 (1977). As early as 1913, Justice *Brandeis* wrote about the "archaic doctrine of caveat emptor" which had to be replaced. See *Brandeis* (N.55), p. 70.

181 Those are discussed in VI.

182 *Wüstemann* (N.44), p. 717.

183 See infra V. 2. b).

184 Rule 10b-5.

185 Rule 14a-9.

186 *Merkt* (N.12), p. 121.

187 If the scope of Rule 10b-5 were limited to the "disclose or abstain" principle, this Rule could not be interpreted as an independent disclosure norm for companies, as no obligation to publish arises from the mere possession of insider knowledge.

out transactions in a company's securities.[188] It should be noted, though, that neither Rule 10b-5 nor the general principle of full disclosure are equivalent to an unrestricted obligation to disclose information, as illustrated in Section V. 2.

b) Fair Disclosure

As to full disclosure, the courts have made it clear that disclosed facts must be fairly represented and that, therefore, an unambiguous representation of the information that is to be disclosed is required.[189] Consequently, the obligation to disclose a material fact is not invariably fulfilled even if the information provided is factually accurate and material. Rather, the context and nature of the representation must be chosen in such a way that investors cannot be mislead.[190] "[T]he disclosure required by securities laws is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead prospective buyers".[191] Thus, if factually true information is "[...] susceptible to quite another interpretation by the reasonable investor", it will be regarded as "material misrepresentation".[192]

2. *The Limits of the Principle of Full and Fair Disclosure*

a) The Limits of Materiality

In U.S. securities laws, the obligation to disclose material information is, essentially, dependent upon the significance of the effect this information may have on the decision-making of its recipients.[193] Thus, for instance, the explicit purpose of financial accounting is "[to] provide information that is useful to present and potential investors and other users in making rational investment, credit, and other decisions".[194] Within the SEC's Fair Disclosure Regulation (Regulation FD), there is a list of potentially material information, albeit with an explicit note that this may not be significant in every case.[195] Previously, the criteria for determining what constitutes a "material" information were

188 See infra IV. 2. a).

189 *Wüstemann* (N.165), pp. 72–73.

190 See Greenapple v. Detroit Edison Co., 618 F.2d 198, 205 (2d Cir. 1980).

191 McMahan & Co. v. Warehouse Entertainment, Inc., 900 F.2d 576, 579 (2d Cir. 1990). See also Lucia v. Prospect Street High Income Portfolio, 36 F.3d 170, 175 (1st Cir. 1994); In re Biogen Sec. Litig., 179 F.R.D. 25, 35 (D. Mass. 1997).

192 SEC v. First American Bank & Trust Co., 481 F.2d 673, 678 (8th Cir. 1973).

193 *Merkt* (N.12), p. 186.

194 Con 1.

195 SEC: Release-No. 33-7881; 34-43154; FR 51716: Final Rule: Selective Disclosure and Insider Trading, 51721. The numerous examples listed there include revenue forecasts, mergers, acquisitions, new products or inventions, as well as changes to customer or supplier relationships, a change of auditor, and share redemption plans. See SEC: Release-No. 33-7881; 34-43154; FR 51716 (24 August 2000): Final Rule: Selective Disclosure and Insider Trading, 51721.

developed primarily in light of the federal courts' interpretation of general disclosure norms such as Rule 10b-5 and Rule 14a-9.[196] Thus, the definition of "materiality" is based on the Supreme Court's ruling in *TSC Industries, Inc.* v. *Northway, Inc.*: In *TSC Industries*, the Court held that information is material, within the meaning of Rule 14a-9, if there is a substantial probability that the publication of the fact or facts concerned would significantly have changed the "total mix of information" from a reasonable investor's point of view and that it would, therefore, have been significant for this reasonable investor's investment decisions.[197] According to this ruling, the deciding factor is the extent to which information is possibly significant for investment decisions, in such a way that it could mislead the investor.

The phrase "reasonable investor" is usually used to measure materiality even though there is still no unambiguous definition of this concept.[198] Nevertheless, it is established that "[t]he question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor".[199] There was a reference in another case to a "reasonable, not schizophrenic, investor" from whose point of view the suitability of the prospectus ought to be judged.[200] In *Richard* v. *Crandall*, it the court held that companies are "not required to address their stockholders as if they were children in kindergarten".[201] On the other hand, it is "not sufficient that overtones might have been picked up by the sensitive antennae of investment analysts".[202] The examples illustrate that the question of materiality is a "mixed question of law and facts",[203] and that, to date, as far as anyone can tell, no definition of materiality has been found which is sufficiently precise. Accordingly, materiality has "to be determined on a case-by-case basis".[204] The matter is clouded further by the fact that, in order to determine materiality, the probability magnitude formula has to be applied to multi-layered decision-making processes and other undetermined, as yet incomplete processes. In other words, the probability that a certain fact could arise must be weighed against the expected effects of this fact on the issuer's assets or business.[205] Nevertheless, the objective concept of materiality represents a significant restriction of the principle of full and fair disclosure. It rules out any comprehensive orientation of information standards towards subjective information interests, as made clear by the court in *Otis & Co.* v. *SEC*. According to the court, an issuer is not under an obligation "to state every fact about stock offered that a prospective purchaser might like to know or that might, if known, tend to influence his decision".[206]

b) How the Concept of Materiality is Related to the Duty to Disclose

The SEC's rules on inside information and its encouragement to publish "soft information" voluntarily make it clear that it is not mandatory to publish all significant information.[207] Obviously, information requirements are limited by competing confidentiality obligations, either in the company's or the investor's best interest.[208] In fact, this limitation is critical for the application of statutory stipulations regarding information content. To solve this problem, one cannot avoid evaluating the opposing interests, as an objectively correct demarcation will hardly be possible.[209] In spite of the fundamental significance of this demarcation for the information model, for securities and capital markets, there are no unambiguous legal guidelines.[210] The SEC confines itself to imposing sanctions for the omission to state material facts, but it does not attempt to clarify the relevant criteria.[211] Hence, the courts are entrusted with the difficult task of reducing the vagueness of the pertinent norms that results from a lack of statutory guidelines for the appropriate interpretation of these norms.

Essentially, judging whether significant information has been omitted presents greater difficulties than discovering false or misleading information,[212] because an "omission to state material facts" does not necessarily amount to a breach of the statutory disclosure obligation because of the fact that "silence

196 See supra V. 1.

197 TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). It is barely possible to separate the ways in which Rule 10b-5 and Rule 14a-9 are fleshed out; the precedents are often interchangeable. For instance, the definition of materiality for purposes of Rule 14a-9 was applied in Elkind v. Liggett to a Rule 10b-5 case. See Elkind v. Liggett & Myers, Inc., 472 F. Supp. 123, 166 (S.D.N.Y. 1978). The U.S. Supreme Court has also explicitly applied it to Rule 10b-5 cases. See Basic, Inc. v. Levinson, 485 U.S. 224, 230 (1988); see also PPM America, Inc. v. Marriott Corp., 853 F.Supp. 860, 868 (D. Md. 1994). *Cf. Loss/Seligman* (N.10), p. 580.

198 *Kitch*, The Theory and Practice of Securities Disclosure, 61 Brooklyn L. Rev. 763, 825 (1995).

199 TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 445 (1976).

200 Greenapple v. Detroit Edison Co., 618 F.2d 198, 208 (1980).

201 Richard v. Crandall, 262 F. Supp. 538, 554 (S.D.N.Y. 1967).

202 Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1297 (2d Cir. 1973).

203 TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976).

204 Basic, Inc. v. Levinson, 485 U.S. 224, 250 (1988).

205 The greater the anticipated consequences are, the earlier one must assume that the event is significant. The landmark ruling on the probability magnitude formula is SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

206 Otis & Co. v. SEC, 106 F.2d 579, 582 (6th Cir. 1939).

207 *Wüstemann* (N.165), p. 156.

208 See, *e.g.* Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 431 (7th Cir. 1987) ("[A] law designed to prevent fraud on investors tolerates silence that yields benefits for investors as a group").

209 *Wüstemann* (N.165), p. 156.

210 *Wüstemann* (N.165), p. 156.

211 *Wüstemann* (N.165), p. 157.

212 *Wüstemann* (N.165), p. 157.

absent a duty to disclose is not misleading under Rule 10b-5".[213] To devise a viable system, one must first distinguish between the materiality of any given information, on the one hand, and the question of whether its disclosure is mandatory, on the other hand. As the U.S. Supreme Court has pointed out correctly, "[...] the concepts of materiality and duty to disclose are different".[214] One must also inquire into whether the information in question is material as defined by courts under Rule 10b-5 and Rule 14a-9. If the information in question is in fact material, one must examine whether there is an obligation to disclose it. Firstly, this obligation exists only within the framework of (periodic) disclosure obligations under federal securities laws, and only if company insiders are trading the company's shares.[215] Secondly, there is a duty to correct "only where necessary to correct a prior statement that remains viable in the market and was inaccurate at the time it was made",[216] *i. e.*, "if it is factually inaccurate or additional information is required to clarify it".[217] This does not mean, however, that once information has been submitted, it must be continually updated.[218] There is no obligation "to disclose a fact merely because a reasonable investor would very much like to know the fact".[219] Therefore, the significance of an item of information does not necessarily imply any obligation to disclose.[220] There is, however, an obligation to disclose if a different statement would be misleading or false without the information in question.[221] In exceptional cases, this also applies to statements by third parties if the issuer is responsible for the inaccuracy of this information or its dissemination by third parties.[222] For example, an issuer must not disclose whether it considers an analyst's profit expectations to be too optimistic. "However, where a company undertakes to pass on earnings forecasts through analysts' reports, it must correct figures that are incorrect".[223]

The fact that Rule 10b-5 does not contain any "freestanding completeness requirement" was made clear in *Brody* v. *Transitional Hospitals Corp*.[224] In this case, the company had provided information in press releases about a share redemption program and the existence of parties interested in a company takeover. The plaintiffs alleged that there was no mention of a possible merger in the first communication and that the second communication did not reveal that there were three actual company offers. The court rejected the lawsuit on the grounds that the omission of the information in question did not make the communications misleading. Neither did the first press release deny that there would be a merger nor did the second press release imply that there were not three actual purchase offers.[225] Similarly, the non-disclosure of the suspected violation of antitrust laws in *In re Miller Industries, Inc. Sec. Litig*. was not adjudicated to be an omission within the meaning of Rule 10b-5.[226] By contrast, in *Kunzweiler* v. *Zero.net Inc.*, the court recognized that the omission in the affirmative representations in the chairman's *curriculum vitae* about his business experience gave rise to liability for misleading information because it lacked a reference to pending securities fraud cases against him as well as to his numerous previous convictions.[227] Obviously, judging whether there could be an omission of material facts is made difficult not only by the vague definition of materiality, but also by the uncertainties surrounding the duty to disclose. Several court decisions emphasize that the standards to be applied are of limited use in practice. The question of when an item of information first became material and, therefore, when an "omission of material facts" could first have occurred, makes this problem even more difficult. Case law suggests that "allegations that defendants should have anticipated future events and made cer-

213 Basic, Inc. v. Levinson, 485 U.S. 224, 239 (n. 17) (1988). "Materiality alone is not sufficient to place a company under a duty of disclosure", see Murphy v. Sofamor Danek Group (In re Sofamor Danek Group), 123 F.3d 394, 400 (U.S. App. 1997). In this case, the court ruled that the non-publication of a dishonest sales practice which made a significant contribution to improved turnover and profit did not constitute an omission contrary to duty. Nor was the non-publication of a planned change in pricing strategy considered to be an omission contrary to duty. See San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Cos, 75 F.3d 801, 810 (2d Cir. 1996).

214 Glazer v. Formica Corp., 964 F.2d 149, 156 (2d Cir. 1992).

215 See Gallagher v. Abbott Labs, 269 F.3d 806, 808–809 (7th Cir. 2001); McCormick v. Fund American Cos., 26 F.3d 869, 875–876 (9th Cir. 1994).

216 In re Harmonic, Inc. Securities Litig., 2002 U.S. Dist. LEXIS 26676, 58.

217 In re Nice Sys., Ltd. Sec. Litig., 135 F. Supp.2d 551, 573 (D.N.J. 2001). For more details on the three cases listed in which an obligation to publish existed, see, *e.g.*, U.S. v. David Rex Yeaman, 987 F. Supp. 373, 378 (E.D. Pa. 1997).

218 Backman v. Polaroid Corp., 910 F.2d 10, 16–17 (1st Cir. 1990); In re Biogen Sec. Litig., 179 F.R.D. 25, 34 (D. Mass. 1997); PPM America v. Marriott Corp., 875 F. Supp. 289, 300–301 (D. Md. 1995).

219 In re Time Warner, Inc. Securities Regulation, 9 F.3d 259, 267 (2d Cir. 1993).

220 Glazer v. Formica Corp., 964 F.2d 149, 156 (2d Cir. 1992); Sofamor Danek Group, Inc. v. Murphy, 123 F.3d 394, 400 (6th Cir. 1994); Oran v. Stafford, 226 F.3d 275, 285 (3d Cir. 2000).

221 See Cutsforth v. Reuschler, 235 F. Supp. 2d 1216, 1230 (M.D. Fla. 2002); Schlifke v. Seafirst Corp., 866 F.2d 935, 944 (7th Cir. 1989); Taylor v. First Union, Corp., 857 F.2d 240, 243–244 (4th Cir. 1988).

222 *Loss/Seligman* (N.10), p. 960.

223 Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 164 (2d Cir. 1980). Also see Alfus v. Pyramid Tech. Corp., 764 F. Supp. 598, 603 (N.D. Cal. 1991); In re Kidder Peaboy Secs. Litig., 10 F. Supp. 2d 398, 407 (S.D.N.Y. 1998); Nanopierce Techs., Inc. v. Southridge Capital Mgmt. LLC US. Dist. LEXIS 11108, 20 (S.D.N.Y. 2003); Stratosphere Corp. Sec. Litig., 66 F. Supp.2d 1182, 1199-1200 (D. Nev. 1999).

224 See Brody v. Transitional Hosps. Corp., 280 F.3d 997, 1006 (9th Cir. 2002).

225 Brody v. Transitional Hosps. Corp., 280 F.3d 997, 1006–1007 (9th Cir. 2002).

226 See In re Miller Industries, Inc. Sec. Litig., 12 F. Supp.2d 1323, 1331 (N.D.G. 1998).

227 Kunzweiler v. Zero.net. Inc., Civil Action No. 3: 00-CV-2553-P, 2002 US. Dist. LEXIS 12080 (N.D. Tex. 2002), 30–35.

tain disclosures earlier than they actually did do not suffice to make out a claim of securities fraud".[228]

VI. Overview of Some Affirmative Disclosure Obligations

Now that the general principle of full and fair disclosure has been discussed, the following section will provide an overview of some specific affirmative disclosure obligations. In this context, a distinction needs to be drawn between disclosure obligations concerning the first-time issuance, approval and registration of securities (*i. e.*, initial public offerings) and the disclosure obligations that arise periodically as to outstanding securities. In addition, one needs to take into account other non-regular disclosure obligations and non-financial information. Under U.S. securities legislation, one can distinguish between the following kinds of disclosure obligations:

- Registration disclosure;
- annual reporting;
- quarterly reporting;
- ad hoc disclosure;
- directors' dealings;
- company stake disclosure.

1. Registration Disclosure

According to the 1933 Act, an initial public offering of securities is permitted only on condition that the issuer submits a registration statement to the SEC and that the application is accepted.[229] Before the application is submitted, all offers for sale are forbidden.[230] There are various forms on which U.S. issuers can submit their approval applications,[231] some of which are only for specific share issuances.[232] There are three forms for standard share issuances; they are basically similar in terms of the information required, but they differ regarding the extent of their disclosure obligations, particularly with regard to the possibility of referring to information already published.[233] Form S-1 contains the most extensive disclosure obligations and can be used by any

228 Novak v. Kasaks, 216 F.3d 300, 309 (2d Cir. 2000). See also Acito v. IMCERA Group, Inc., 47 F.3d 47, 53 (2d Cir. 1995).

229 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 853.

230 See Section 5 of the 1933 Act. According to the definition in Section 2(a)(3) 1933 Act, however, negotiations and agreements between the issuer and the issuing bank are not offers for sale, which means that all the contracts necessary in this context can be signed.

231 See *Hazen* (N.67), § 3. 4.

232 For example, Form S-4 is for share issuances relating to mergers, and Form S-8 is for share issuances in which shares are only issued to company employees as part of their employee benefit plans.

233 *Soderquist/Gabaldon* (N.87), pp. 64–66.

U.S. issuer, whereas the second form (Form S-2) does not require as much disclosure but can only be used by companies which have fulfilled their disclosure obligations with respect to the SEC, as required by the 1934 Act, for at least three years. If this application is chosen, certain information obligations can be fulfilled, in accordance with the 1934 Act, by referring to current information already submitted to the SEC. The third form (Form S-3), which requires the least amount of disclosure, can only be chosen by companies which have fulfilled the disclosure obligations of the 1934 Act for at least one year, and even then only if shares in the company amounting to at least $75,000,000 are held freely (not by associated companies), or if the company issues only gilt-edged securities.

a) Form S-1

Form S-1 is primarily for the registration of issuers which have not been subject to the secondary market disclosure obligations of the 1934 Act at all, or which have been subject to them for less than three years. Companies applying for first-time approval are subject to full issuance disclosure obligations, without any possibility of referring to previously submitted publications. Hence, the information given in Form S-1 must comprehensively fulfill all the disclosure obligations stipulated by the SEC regarding primary market disclosure.[234] Form S-1 consists of two parts, each of which has a different scope and different requirements.

aa) First Part

The first part of Form S-1 is very extensive and includes the basic information package. The contents of this part correspond to the issuance prospectus which must be distributed to shareholders. Most importantly, it contains all issuance and management data regarded as relevant for investors' investment decisions.[235] In the first part of Form S-1, the significant content appears as follows: For Item 1, a data overview must be provided on the front page of the issuance prospectus. This overview primarily includes data concerning the issuer and the securities. The name of the issuer, the nature and number of the securities (possibly with a more detailed description), the offering price of the securities, including discounts for consortium banks, and the issuer's net proceeds, both for each individual share and for the whole package, are mandatory. This information must be given in easy to understand language.[236] In Item 2, the relevant information must be submitted on the inside or back page. There must also be an instruction to the broker or banker that a prospectus must be distributed, at the latest, when the securities are sold.[237] In Item 3, a

234 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 853.

235 *von Kirchbach* (N.3), p. 38.

236 Item 1 of Form S-1; Section 501 of Regulation S-K.

237 Item 2 of Form S-1; Section 502 of Regulation S-K.

brief summary of the information contained in the registration application must be provided. The postal address and telephone number of the issuer's administrative headquarters must also be given.[238] Immediately after this summary, all risk factors must be listed, particularly the newness of the business, risky business sectors, foreseeable financial risks, and any commerce which has recently been unprofitable.[239] A cost-revenue ratio must also be produced. In other words, information must be provided on the ratio of earnings to fixed costs for each category of securities. This information must be provided for the last five years and the last period between reports listed in the prospectus.[240] In Item 4 of Form S-1, the ways in which the issuer plans to use the issuance proceeds, or the reasons for the issuance, must be explained in detail.[241] If no use of the issuance proceeds is planned, the reasons for the issuance must be stated. In Item 5, the issue price must be specified. Here, the factors which contributed to the specification of the offering price must be explained.[242] If the proprietary capital investors' position is vulnerable to a dilution, specific information concerning the value of the securities must be given in Item 6.[243] When there is a discrepancy between the issue price and the price actually paid, there is a dilution. The information provided must contain the net book value per share of the material assets, the increase in this value resulting from the payments of share buyers, and the sum of the dilution in relation to the offer.[244]

Item 7 requires detailed information concerning the security holders selling their securities (which are yet to be registered) in the public offering.[245] Most importantly, the names of these shareholders, information about their relationships with the issuer over the last three years, and the sizes of their stakes must be provided.[246] Moreover, in Item 9 of Form S-1, a detailed description of the securities issued is mandatory.[247] In particular, the type of security must be stated, *i.e.*, whether the securities are joint stock shares, bonds, or rights to or options on securities, and specific details on the type of security, such as dividend rights, voting rights, conversion rights etc., must be provided. In Item 10 of Form S-1, any adviser's possible personal interest must be disclosed. This disclosure must cover all possible relationships between the issuer and its consulting lawyers and other expert consultants who contributed to the pro-

238 Item 3 of Form S-1; Section 503 (a) and (b) of Regulation S-K.
239 Item 3 of Form S-1; Section 503 (c) of Regulation S-K.
240 Item 3 of Form S-1; Section 503 (d) of Regulation S-K.
241 Item 4 of Form S-1; Section 504 of Regulation S-K.
242 Item 5 of Form S-1; Section 505 of Regulation S-K.
243 Item 6 of Form S-1; Section 506 of Regulation S-K.
244 *von Kirchbach* (N.3), p. 40.
245 Item 7 of Form S-1; Section 507 of Regulation S-K.
246 *von Kirchbach* (N.3), p. 41.
247 Item 9 of Form S-1; Section 202 of Regulation S-K.

duction of the registration application.[248] The most significant question is whether, in the context of the securities offer yet to be approved, the persons listed will receive securities with a considerable combined value, which must be taken to mean a value of more than US $50,000.[249] The data required for the basic information package must be listed in detail in Item 11. These include detailed information about the issuer's company.[250]

Item 11 requires detailed and comprehensive information about the issuer, including its business performance over the last five financial years, or since its foundation, and its assets. A profit and loss statement, a turnover statement and a detailed description of the business must be submitted as well. The issuer's investments and business premises must also be listed, as must any significant pending court cases. Moreover, the markets on which shares of the same category are already being traded must be disclosed, as must the annual or consolidated financial statements, with figures for the last two to three years. Selected financial data – specifically, net turnover, operating result in total and per ordinary share, increase in total assets, retractable preferred shares, cash dividend per ordinary share, and long-term debts – must also be listed. Furthermore, as part of the information about the issuer, the company's executive board, top managers and employees with particularly important roles must be introduced. In addition, the securities owned by company insiders and transactions with company insiders must be disclosed.[251] Item 12 of Form S-1 also requires a copy of the SEC stipulation concerning the limitation of liability for executive board members and top managers.[252] In the opinion of the SEC, exemptions from liability are in violation of public policy.[253]

bb) Second Part

Unlike the first part, the second part of Form S-1 does not form part of the issuance prospectus. This is to reduce expenses, as the second part is not regarded as especially relevant to the average investor's decision-making.[254] Instead, the second part of Form S-1 forms the basis of the SEC's supervisory activities. However information in this part of the form is still available to the public through the SEC. This information is used primarily by professional investors who hope that it will provide interesting additional details, enabling them to make better-informed decisions.[255]

248 Item 10 of Form S-1; Section 509 of Regulation S-K.
249 *von Kirchbach* (N.3), p. 41.
250 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 855.
251 Item 11 of Form S-1; Sections 101, 102, 103, 201, 301, 302, 303, 403, 404 of Regulation S-K.
252 Item 12 of Form S-1; Section 510 of Regulation S-K.
253 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 855.
254 *von Kirchbach* (N.3), p. 44.
255 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 853.

The contents of part two of Form S-1 can be summarized as follows. In Item 13, issuance costs must be disclosed.[256] Further information in the issuance prospectus relates to agreements limiting the liability of managers and directors, which take the form of decrees, agreements or contracts limiting the liability of the executive board, or even exempting it from liability, as well as company members' related affidavits (Item 14).[257] Information regarding sales of securities not registered in accordance with the 1933 Act must also be communicated (Item 15).[258] The consortium contract, memorandum of association, articles of association and other important contracts must be included as attachments.[259]

b) Form S-2

Form S-2 is largely identical to Form S-1, but it sets fewer disclosure obligations. It can, however, only be used by companies that have fulfilled their regular disclosure obligations with respect to the SEC, in accordance with the 1934 Act, for at least three years.[260] It makes completing an application easier for issuers that have already been registered with the SEC for some time, have fulfilled their regular disclosure obligations with respect to the SEC and to their shareholders, and have made punctual dividend and interest payments. They have the option of submitting shorter approval applications. Nevertheless, Forms S-2 und S-3 are only minimum standards. Companies may provide further information on a voluntary basis.[261]

Form S-1 differs from Form S-2 in that the detailed accounting data required in Item 11 can be provided in brief references to periodic reports. The issuer can choose to submit either the last annual financial statements or the annual report sent to its shareholders, in addition to the latest quarterly report, or to provide a large part of the financial information required in Form S-1 explicitly in the prospectus.[262] Form S-2 also differs from Form S-1 regarding the information which the latter requires in Item 12 and concerning company insiders.[263] Otherwise, Form S-2 is no easier to complete than Form S-1.[264]

c) Form S-3

Form S-3 requires the least disclosure from the issuer. The Form can only be selected by companies which have fulfilled their disclosure obligations according to the 1934 Act for at least one year, and in which shares with a com-

256 Item 13 of Form S-1; Section 511 of Regulation S-K.
257 Item 14 of Form S-1; Section 702 of Regulation S-K.
258 Item 15 of Form S-1; Section 701 of Regulation S-K.
259 Item 16 of Form S-1; Section 601 of Regulation S-K.
260 *von Kirchbach* (N.3), p. 38.
261 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 854.
262 *von Kirchbach* (N.3), p. 45.
263 *Hazen* (N.67), § 9. 7.
264 *von Kirchbach* (N.3), p. 45.

bined value of at least US $75,000,000 are held freely.[265] Here, disclosure obligations are made so much easier that merely referring to annual reports and to information submitted after their publication is sufficient.[266]

d) Forms SB-1 and SB-2

In addition to the forms mentioned above, there are special approval application forms for smaller U.S. and Canadian companies, known as "small business issuers", with annual sales of less than U.S. $25,000,000 and with shares traded on the market with a combined value of less than U.S. $25,000,000.[267] Equally, the forms provided for these issuers, SB-1 and SB-2, set less demanding disclosure obligations.[268] Form SB-2 contains more extensive disclosure obligations than Form SB-1 and can be used by all small business issuers. In contrast to Form S-1, Form SB-2 requires all financial data and Managament's Discussion & Analysis (MD&A) only for the last two years and in a less detailed form.[269] The descriptive and explanatory parts of the prospectus also require less detailed entries. Form SB-1 can be used only by issuers applying for the approval of securities with a combined value of no more than $10,000,000 within a 12-month period.[270] This form makes publication significantly simpler and easier. For example, an MD&A is not mandatory for Form SB-1.[271] Nevertheless, the same financial data have to be submitted, whether the application is made using Form SB-1 or Form SB-2.[272]

2. Annual Reporting

The most significant regular disclosure obligations for U.S. corporations arise from the annual reporting obligation. Securities issuers must regularly submit information about their companies to the SEC using the forms provided for this purpose. Their annual reports are publicly accessible via the EDGAR database. These are the three pillars of annual reporting:
- the annual financial statements using Form 10-K,
- the annual report, and

265 *Hazen* (N.67), § 9. 7.
266 *von Kirchbach* (N.3), pp. 38, 46.
267 Subsidiaries only have this option, however, if the parent company itself can also be designated as a "small business issuer". See Rule 405 and Item 10 of Regulation S-B.
268 The option of an approval application with less demanding requirements than those for Form S-1 is also available for all issuers (including small business issuers) wishing to apply for the approval of securities with a combined value of less than $5,000,000 – see SEC Regulation A and the corresponding approval application form, Form 1-A. This is even easier to complete than Form SB-1, as it does not require any attested statements. See *von Kirchbach* (N.3), p. 47.
269 Item 17, 22 of Form SB-2; Item 303, 310 of Regulation S-B.
270 General Instructions A of Form SB-1.
271 Form SB-1.
272 Part F/S of Form SB-1; Item 310 of Reg. S-B.

– the proxy statement.[273]

The regular disclosure obligation applies only to companies with shares traded on the stock exchange in the over-the-counter (OTC) market if they have at least 500 shareholders and company capital of at least US $5 million.[274] The requirements of regular disclosure obligations – for both annual reports and quarterly reports, (which will be described below) – are stipulated in Section 13 of the 1934 Act, and they are amended and extended in the Sarbanes Oxley Act.[275]

a) Form 10-K

The most extensive source of annual information is the publication of the annual report which must be published according to Regulation S-X and conform to the requirements of Form 10-K.[276] The annual report must be submitted to the SEC within 90 days of the end of the fiscal year, or within 60 days for large corporations whose securities in public ownership have a combined value in excess of U.S. $75,000,000. In publishing their annual reports, companies can refer to existing documents. In particular, they can refer to previously published annual reports (which is known as "incorporation by reference"). This corresponds to the system of integrated disclosure.[277] Form 10-K consists of four parts.

aa) Part I

Part I of the form is primarily concerned with business activities during the last fiscal year.[278] Information about general business developments, particularly significant events in the fiscal year, such as a subsidiary's going bankrupt, major acquisitions or disinvestments, or changes in the nature of the executive board, is mandatory. The description of business activities must also contain a report about the sector in general.[279] Furthermore, if the issuer is an international entity, it must be geographically segmented on a country-by-country basis.[280] In addition to the basic information package (see Part II), information about business premises, court cases and annual general meeting procedures is also compulsory.[281] Equally, the decisions made in a shareholders' meeting in the fourth quarter of last year must be reported in Part I of Form 10-K.[282]

273 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 857.
274 *von Kirchbach* (N.3), p. 71.
275 *Coffee/Seligman* (N.41), p. 2.
276 *Baker/Rapaccioli/Solomon* (N.52), p. 2994.
277 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 857.
278 Item 1 of Form 10-K, Section 101 of Regulation S-K.
279 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 858.
280 *von Kirchbach* (N.3), p. 72.
281 Item 2 of Form 10-K; Section 102 of Regulation S-K; *cf. Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 858.
282 Item 4 of Form 10-K.

bb) Part II

Part II of Form 10-K contains the basic information package. Information concerning the market prices and dividends of ordinary shares is also required. This includes market information – most importantly, that about the market sector and the highest and lowest price for each quarter over the last two years. In addition, the numbers of shareholders per ordinary share category must be listed, and the sums and frequency of dividends over the last two years must also be included.[283] Moreover, Item 6 requires selected financial data for the last five years.[284] These financial data must be provided in tabular form to compare them to data from previous years; and, depending on the issuer, there may be data for net sales, operating success, profits or losses from ongoing business in total or per individual share, total asset value and long-term debts. This part of Form 10-K must also contain a MD&A discussing trends in liquidity, capital provision and revenue both retrospectively and prospectively.[285] The purpose of the MD&A is to make it possible for investors to see the company through management's eyes, as it were, by preparing a short and long-term analysis of the company's business, both past and future.[286] As regards liquidity, trends or events likely to improve or worsen liquidity must be mentioned, as must any relevant measures which the company intends to take. Both internal and external sources of liquidity must be included, as must liquidity reserves.[287] To fulfill the reporting obligation concerning capital sources, the issuer must also include other financial obligations, trends in capital provision, and expected changes in capital structure and costs.[288] When representing the revenue situation, one must include the sum of the results of extraordinary events and transactions, trends and uncertainties relating to sales and ordinary results, causes of significant increases in sales, and the effect of inflation on the revenue situation over the last three years.[289] In Item 7A of Part II of Form 10-K, quantitative and qualitative information about existing market risks, such as a value-at-risk analysis, currency risks or raw material risks, must also be included.[290] The obligation to publish in Form 10-K also extends to the annual or consolidated financial statements, as well as additional financial information. These include balance sheets, profit and loss statements, a capital flow statement and an account of proprietary capital changes.[291] The issuer is also obligated to publish any change of auditor or dif-

283 Item 5 of Form 10-K; Section 201 of Regulation S-K.
284 Item 6 of Form 10-K; Section 301 of Regulation S-K.
285 Item 7 of Form 10-K; Section 303 of Regulation S-K; *cf. Watrin* (N.49), p. 55.
286 *von Kirchbach* (N.3), p. 73.
287 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 858.
288 *von Kirchbach* (N.3), p. 73.
289 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 859.
290 Item 7A of Form 10-K; Section 305 of Regulation S-K.
291 See *Watrin* (N.49), p. 55.

ference in opinion between company and its auditors in the last two years[292] and to submit information about the controls and processes intended to guarantee effective company disclosure.[293] Other information has to be provided, including anything reported *ad hoc* in Form 8-K in the last quarter.[294] In addition, companies are encouraged voluntarily to submit future-oriented information.[295]

cc) Part III

In Part III of Form 10-K, detailed information about the executive board and top managers must be provided, as must details of management pay. The non-financial information which must be provided here is, to a large extent, the same as that required in Form S-1. The information relating to the executive board and directors must include personal data, such as name, age, position and term of office, as well as the ways, if any, in which executive board members and directors are related. Career experience over the last five years and other director posts are also significant. In addition, information must be provided concerning any legal proceedings in the last five years which are relevant to an assessment of the management.[296] Most importantly, the pay for each individual executive board member and director must be disclosed. The total remuneration of the CEO and the four next highest paid managers for the last three years must be represented in a table. Furthermore, details of all share options, whether granted or exercised, and emoluments dependent on share prices must be given, and payments from the long-term incentive plans and pension rights of the executive board and top management must be listed.[297] Disclosure obligations also apply to the number of shares owned by each person in the company who owns more than 5 % of the issuer's voting shares. The number of shares owned by board members, top managers and the four best-paid executives, both individually and in total, must be listed.[298] Information must also be provided about possible transactions with company insiders and significant contracts.[299] All members of the executive board, top managers or shareholders with a stake in the company of over 5 % must be listed. The value of the transactions or contracts must be at least US $60,000.[300] The relationship between a company with reporting obligations and a customer, supplier or creditor with an executive who is also a director in the aforementioned company is also subject to disclosure obligations. Further-

292 Item 9 of Form 10-K; Section 304 of Regulation S-K.
293 Item 9A of Form 10-K; Sections 307, 308 of Regulation S-K.
294 See supra VI. 4. a).
295 *von Kirchbach* (N.3), p. 74.
296 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 859.
297 Item 11 of Form 10-K; Section 402 of Regulation S-K.
298 Item 12 of Form 10-K; Section 403 of Regulation S-K.
299 *Watrin* (N.49), p. 55.
300 Item 13 of Form 10-K; Section 404 of Regulation S-K.

more, the level of executives' debt must be given if it is equal to or greater than US $60,000.[301] As well as management pay, all fees paid to auditors and tax accountants in the last two years, including fees relating to audits, must be listed on Form 10-K for the annual financial statements. Fees for any other kind of consultancy service provided by auditors must also be given.[302]

dd) Part IV

Attachments and tables must be included in Part IV. These deal primarily with matters reported as *ad hoc* disclosure in Form 8-K.[303] Schedules which form part of the annual financial statements must also be listed here.[304]

b) Advantages for Foreign Firms

There are certain advantages for foreign issuers listed on an American stock exchange. They are entitled to use a special form, Form 20-F, instead of Form 10-K. In particular, the annual report, which must be compiled and attested to in accordance with US GAAP, can nevertheless be prepared on the basis of domestic financial accounting standards – primarily IFRS – as long as the equity capital and results are reconciled with US GAAP.[305]

c) Annual Report

The regular disclosure obligations to which U.S. corporations are subject also include the annual report, which is prepared for the annual general meeting of current shareholders. The obligation for listed companies to provide annual information for their shareholders is not derived directly from authoritative regulations or statutory provisions, as the federal legislature lacks competence to legislate for this. The Securities Exchange Act sets an obligation to produce an annual report, but only in connection with the duties provided in Section 14 concerning the annual general meeting.[306] According to the latter, the annual report must at least contain the basic information package. For a long time, producing an annual report was seen by listed companies in the U.S. purely as an investor relations instrument. Then, indirectly via proxy regulations, the SEC formulated requirements for an annual report. This made the annual report more valuable and significant for shareholders.[307]

301 *von Kirchbach* (N.3), p. 81.
302 Item 14 of Form 10-K.
303 See supra VI. 4. a).
304 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 860.
305 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 861.
306 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 861.
307 *Skousen* (N.115), pp. 76-77.

d) Proxy Statement

aa) Purpose

It is possible for the shareholders of U.S. corporations to be represented by the executive board or third parties at the annual general meeting of shareholders or any other shareholders' meeting. Proxies must be provided for this purpose. The legal foundations of proxy statements can be found in various State statutes (specifically regarding the authorization of representatives) and in federal legislation, specifically in the regulations of the state stock market supervisory body, the SEC.[308] The recipients of authorization are, in principle, the executive body of American public companies that are typically interested in securing high attendance quorums;[309] but they can also be third parties. A company's executive bodies usually solicit proxies from the shareholders (this is known as proxy solicitation).[310] Executives and third parties who solicit proxies from shareholders in public companies are also subject to the SEC's extensive body of regulations. The regulations ensure that the transfer of voting rights to voting agents is subject to the company's information obligations regarding its shareholders.[311] This is intended to enable shareholders to weigh the opportunities against the risks associated with the delegation of their voting rights, and to avoid any possible abuse of proxies granted.[312]

bb) Content

If, before an annual general meeting of shareholders, members of the management of the company concerned contact shareholders in order to receive proxy authorizations, all documents distributed to shareholders as part of this contact must be disclosed.[313] The SEC interprets the concept of contact very broadly, and it includes every communication to a shareholder which could lead the latter to waive his or her right to vote.[314] The publication of an advertisement in a non-regional newspaper can also be regarded as a communication to the shareholders;[315] even open letters to executive bodies of the issuer

308 *Ruoff*, Stimmrechtsvertretung, Stimmrechtsermächtigung und Proxy-System – Stimmrechtsausübung durch Intermediäre in Aktionärsversammlungen – Deutschland, Schweiz und USA im Rechtsvergleich, 1999, p. 178.

309 *Wohlwend*, Die Hauptversammlung im Wandel der Kommunikationsformen, 2000, p. 26.

310 SEC-Rule 14a-1 (l). Proxy solicitation is carried out by sending preprinted proxy cards which always contain further information about the authorization and other instructions; see SEC-Rule 14a-4.

311 See infra VI. 2. d).

312 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 861.

313 Section 14(a) 1934 Act.

314 17 C.F.R. § 240.14a-1(f).

315 Long Island Lighting Co. v. Barbash, 779 F.2d 793 (2nd Cir. 1985).

concerned can be regarded as such.[316] The items of information to be published are primarily management-related data and information which must be completed in the annual report.[317] To fulfill the information obligations in Section 14(a) of the 1934 Act and the related regulation, Regulation 14A, SEC Form 14A must be submitted along with copies of the documents to be sent to the shareholders. This applies to both to third parties receiving proxy voting authorizations and the executive board of the company itself, irrespective of whether voting rights are to be solicited, or the annual general meeting documents are simply to be published.[318]

3. Quarterly Reporting

Like annual reporting and proxy statements, the regular disclosure obligations for listed U.S. corporations also include an obligation to publish quarterly or interim reports. Quarterly reports must correspond to Form 10-Q. They must be submitted to the SEC within 45 days of the end of each of the first three quarters of the fiscal year, or within 35 days for companies that freely hold shares which have a combined value of more than US $75,000,000. No quarterly report must be published for the fourth quarter, as its deadline coincides with that for the annual financial statements.[319] While detailed information is also required here, most of the mandatory information in quarterly reports is quantitative.[320] Form 10-Q consists of two parts, which shall be discussed in greater detail below.

a) Part I

Part I of Form 10-Q for quarterly reports requires an abridged and summarized consolidated balance sheet, a consolidated profit and loss statement, and a cash flow statement.[321] An abridged MD&A is also mandatory.[322] Here, management must discuss all significant developments since the end of the last fiscal year.[323] An analysis of quantitative and qualitative information about existing market risks, known as a value-at-risk analysis, is also required. Moreover, there must be reporting on some of the other non-financial information contained in the annual financial statement.[324] Information about the controls and procedures intended to ensure effective company disclosure must also be in-

316 Brown v. Chicago, Rock Island & Pacific Railroad Co., 328 F.2d 122 (7th Cir. 1964); Gillette Co. v. RB Partners, 693 F.Supp. 1266 (D.Mass.1988).

317 *von Kirchbach* (N.3), p. 92.

318 *von Kirchbach* (N.3), p. 94.

319 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 862.

320 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 864.

321 Item 1 of Part I of Form 10-Q; Rule 10-01 of Regulation S-X.

322 Item 2 of Part I of Form 10-Q; Rule 303 of Regulation S-K.

323 *Watrin* (N.49), p. 56.

324 *Watrin* (N.49), p. 56.

cluded in Part I of Form 10-Q.[325] This Part requires an assessment of whether there is any guarantee that the company's disclosure obligations will be correctly fulfilled.[326]

b) Part II

Part II of Form 10-Q requires further information about the last quarter from registered companies. Firstly, details of pending court cases must be given.[327] Quarterly reports must also contain information about changes in company securities and any encroachments on shareholders' rights.[328] Any defaults on significant debts amounting to a specified minimum sum and preferential dividends must be reported.[329] Other significant information concerns the ballot issues and voting results of any shareholders' meetings which have been held.[330] Furthermore, any other information regarded by the issuer as worth publishing, and which has not already been published in Form 8-K (in an *ad hoc* report), must be disclosed. Finally, attachments and reports in Form 8-K must also be added.[331]

4. Ad hoc Disclosure

Irregular *ad hoc* disclosure is a special characteristic of U.S. securities laws. This disclosure obligation follows from the disclosure philosophy and its purpose is to provide the capital market promptly with all information of significance for the evaluation of traded securities.[332]

a) Form 8-K

Ad hoc disclosure must be provided if certain situations arise. There are conclusive regulations concerning company events for which an information obligation exists. These events must be reported in Form 8-K. If an event covered by Form 8-K occurs, the required information must be submitted to the SEC, along with a detailed discussion including the expected consequences. The list of events which must be published has been considerably extended by the new regulations introduced by the Sarbanes-Oxley Act concerning information and disclosure obligations in U.S. securities law.[333]

Any changes in company control must be communicated in Form 8-K. Here, the persons who have taken over company control must be listed. More-

325 Item 4 of Part I of Form 10-Q; Rules 307, 308 of Regulation S-K.
326 *von Kirchbach* (N.3), p. 82.
327 Item 1 of Part II of Form 10-Q; Rule 103 of Regulation S-K.
328 Item 2 of Part II of Form 10-Q; Rules 701, 703 of Regulation S-K.
329 Item 3 of Part II of Form 10-Q.
330 Item 4 of Part II of Form 10-Q.
331 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 863.
332 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 864.
333 *von Kirchbach* (N.3), p. 113.

over, a brief description must be given of the transaction which led to the change in control. Pledge agreements which concern the issuer's shares and could lead to the replacement of the issuer's controller at a later date must also be disclosed.[334] The disclosure obligations also cover information regarding a possibility of bankruptcy, an application by the company for protection from creditors, or a foreclosure order. The exact details of the court or authority at which the bankruptcy or foreclosure proceedings are pending must be given.[335] Listed capital market companies must also disclose any change of auditor, and whether the auditor gave up its mandate or completed its contract with the company.[336] If the auditor's published representations of the company's financial situation contain errors, then a brief yet detailed description of the relevant facts must be published.[337] Obviously, any changes in the company management or top company personnel must also be disclosed, as must the circumstances which led to the changes.[338] If a new member is appointed as a top manager without having been voted for by shareholders at an annual general meeting, this must also be communicated in Form 8-K. The new top manager's name, the date of his or her appointment and a brief description of the relevant agreements must be given here. Furthermore, any transactions carried out by the new top manager or his or her close relatives with the issuer within the last fiscal year must be listed if the total volume of these transactions amounts to more than US $60,000.[339] The *ad hoc* disclosure obligation also covers significant decreases in value, hence, the purchase or sale of significant assets outside the realm of normal commercial activities. An asset is regarded as significant either if its book value, purchase price or sale price is greater than 10 % of the company's total assets, or if it is a significant part of the business.[340] Detailed information must be provided here, including the date of the transaction, the assets concerned, the persons involved, and their relationship with the issuer or one of its executives. The size and origin of the consideration are also significant.[341]

Furthermore, any significant impairment of or deterioration in significant parts of the company, securities or goodwill must be disclosed in Form 8-K.[342] There is also an obligation to publish if the issuer, or someone acting on its behalf, comments on the figures in quarterly or annual financial statements or on the company's financial situation, especially if the relevant regular mandatory financial statements have not yet been published, or if the comments in

334 Item 5.01 of Form 8-K.
335 Item 1.03 of Form 8-K.
336 Item 4.01 of Form 8-K.
337 *von Kirchbach* (N.3), p. 119.
338 Item 5.02 of Form 8-K.
339 Item 5.02 of Form 8-K.
340 Item 2.01 of Form 8-K.
341 *von Kirchbach* (N.3), p. 115.
342 Item 2.06 of Form 8-K.

question retroactively change annual financial statements which have already been published.[343] In addition, U.S. corporations are under the *ad hoc* disclosure obligation to publish details of any significant new contracts which they have signed, and of any major changes to existing significant contracts, outside the realm of normal commercial activities.[344] The parties to the contract, their connection with the reporting company, and the date, terms and conditions of the contract must all be disclosed.[345] If a significant agreement outside normal commercial activities is cancelled, this must also be reported in Form 8-K if this cancellation has a significant effect on the company.[346]

Ad hoc disclosure obligations also cover immediate debts incurred by the company. These must be understood as short-term debt outside the realm of normal commercial activity, long-term debt or significant capital or operating lease obligations. In this context, the reporting corporation's significant debts must also be published.[347] The amount of each liability, a description of each transaction, the stipulations for extending the repayment deadline or increasing the sum, and other important conditions must all be provided. In addition, events which cause the company to incur debts more quickly, or which increase the extent of these debts, must be disclosed.[348] These events include trigger events such as default, accelerated maturity or other contractually agreed events which could significantly bring forward the repayment deadline or increase the repayment sum.[349] U.S. corporations within the ambit of the federal securities laws are also under an obligation to disclose, in Form 8-K, significant costs related to setting up company branches. Detailed information must be provided here.[350] Significant changes in the rights of holders of securities (*i. e.*, shareholders' rights) must also be reported.[351] Other *ad hoc* disclosure obligations in Form 8-K include changes made to the company's articles of association and changes to the company's fiscal year. Here, the date on which the respective change was decided upon must be given, as must a brief description of the change.[352] Other information must also be communicated according to *ad hoc* disclosure obligations, such as trading restrictions relating to business pension plans[353] and changes to the company's code of conduct.[354] It must be noted that obligations to publish relate not only to the company

343 Item 2.02 of Form 8-K.
344 Item 1.01 of Form 8-K.
345 *von Kirchbach* (N.3), p. 114.
346 Item 1.02 of Form 8-K.
347 Item 2.03 of Form 8-K.
348 Item 2.04 of Form 8-K.
349 *von Kirchbach* (N.3), p. 116.
350 Item 2.05 of Form 8-K.
351 Item 3.03 of Form 8-K.
352 Item 5.03 of Form 8-K.
353 Item 5.04 of Form 8-K.
354 Item 5.06 of Form 8-K.

itself, but also to associated companies. In particular, the annual financial statements of any companies bought or sold must be submitted.[355] The information required by Regulation FD must also be disclosed in Form 8-K. "Other events" are not described in detail in Form 8-K. These events relate to securities which convert previously non-liquid assets into fixed interest securities.[356] There is no publication deadline for other events.[357] Nevertheless, the issuer is entitled and able to communicate any event which it considers worth publishing *ad hoc* in Form 8-K.[358]

b) General Clause

Like the mandatory *ad hoc* information content in Form 8-K, one must take account of additional disclosure obligations stipulated by the stock exchange on which the relevant securities are listed. There is, for instance, a general clause stipulated in the terms and conditions of the large U.S. stock exchanges. According to this clause, significant or material information which could have an immediate effect on the value of the registered securities or influence the decisions of market participants, and in whose publication investors have a justified interest, must be published. This information includes, for instance, information on significant mergers, acquisitions, profits or dividends.[359]

5. Directors' Dealings

In the U.S., the disclosure of directors' dealings comes under the heading of insider trading regulations. Thus, in other words, the disclosure regulations are intended to prevent insider trading.[360] But their aim is also to enable investors to make informed decisions concerning their transactions, to improve confidence in the capital market through greater transparency, and to ensure macro-financial stability. Section 16 of the 1934 Act contains stipulations for directors' dealings, and these provisons apply to all companies approved by the SEC in accordance with Section 12 of the 1934 Act – in other words, companies which either have their securities traded on a stock exchange or have an actual net worth of at least $10 million or more than 500 shareholders.[361] Hence, a large proportion of over-the-counter (OTC) issuers are subject to these regulations. According to Section 16 of the 1934 Act, "directors", "officers" and owners of 10 % or more of one category of the issuer's securities have reporting obligations. This provision takes three separate regulatory ap-

355 *von Kirchbach* (N.3), p. 121.
356 Item 6 of Form 8-K.
357 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 865.
358 Item 8.01 of Form 8-K.
359 *Pellens/Fülbier/Gassen/Sellhorn* (N.76), p. 866.
360 *Jutzi* (N.43), p. 15.
361 For many foreign issuers, there are exemptions from the requirements stipulated in Section 16 of the 1934 Act, Rule 3a12-3, 17 C.F.R. § 240.3a12-3.

proaches to achieve the primary goal of preventing insider trading. Section 16(a) of the 1934 Act stipulates that anyone who becomes a "director", an "officer" or an owner of 10 % or more of one category of an issuer's securities must disclose, to both the SEC and the stock exchange on which the securities are traded, how many shares she or he holds,. In addition, any change in the number of shares held must be reported to the SEC within two days, using electronic forms. This information is then immediately published by the SEC on its Internet site. Section 16(b) of the 1934 Act provides a right of action for the company, or an individual shareholder acting for the company's benefit, whereby profits made by "directors", "officers" or owners of 10 % or more by buying and selling (or selling and buying) within a six month period can be absorbed. Section 16(c) of the 1934 Act forbids short selling by "directors", "officers" and owners of 10 % or more. Even securities not actually owned by an individual with reporting obligations, but in which the latter has a pecuniary interest, are attributed to him or her, respectively.[362]

Section 16(a) of the 1934 Act requires an entry report when the status of the individual with reporting obligations is obtained. This entry report must be completed using Form 3 and must disclose the number of shares and other financial instruments held in his or her company by the individual with reporting obligations.[363] If a company is approved for the first time in accordance with Section 12 of the 1934 Act, all those with reporting obligations must report all their transactions in the last six months before the approval. The ongoing reporting obligation in Section 16(a) of the 1934 Act requires that each individual with reporting obligations must also report any change in his/her number of shares using Form 4 within two working days.[364] On this form, the individual with reporting obligations and the issuer concerned must be named, and the details of the relevant transaction must be presented in a table. In particular, the purchase and granting of options must be reported. This reporting obligation only applies, however, to a minimum total transaction volume of $10,000 within six months. Furthermore, gifts, inheritances and mergers do not have to be reported immediately.[365] Transactions below the minimum total volume and other forms of purchase exempt from the continuous reporting obligation must, however, be reported separately in Form 5 within 45 days of

362 This applies especially to securities held by close relatives or spouses who live in the same household. Because of the refutable suspicion in SEC Rule 16a-1(a)(2)(i)(A), they are attributed to the individual with reporting obligations and, thus, are subject to Section 16(a) of the 1934 Act. According to various court rulings, similar conditions apply to Section 16(b) of the 1934 Act; see Whiting v. Dow Chemical Co., 523 F.2d 680 (2d Cir. 1975); C.B.I Industries, Inc. v. Horton, 682 F.2d 433 643 (7th Cir. 1982).

363 17 C.F.R. § 240.16a-3(a).

364 17 C.F.R. § 240.16a-3(f); 17 C.F.R. § 240.16a-6(a); Sec. 403 (a) Public Company Accounting Reform and Investor Protection Act.

365 17 C.F.R. § 240.16b-5.

the end of the calendar year. The same information is required for Form 5 as for Form 4; more specifically, the transaction carried out must be represented succinctly in a table in Form 5. Transactions below the minimum total volume must even be mentioned along with the next transaction to be subject to continual reporting obligations, if the latter is reported before Form 5 report is submitted.[366] Even if an individual is no longer subject to reporting obligations, she or he is under an obligation to disclose any transaction which takes place not more than six months after his/her last transaction as an individual subject to reporting obligations.[367]

6. Company Stake Disclosure

Company stake disclosure obligations are provided for in Sections 13(d), (e) and 16(a) of the 1934 Act. The company stake situation must also be disclosed in the prospectus and in the regular reports.[368]

a) Company Stake Disclosure according to Section 13(d) of the 1934 Act

The purpose of Section 13(d) of the 1934 Act is to keep the market informed of any possible shifts in power relations within a company.[369] The provision concerns shareholders in every company registered in accordance with Section 12 of the 1934 Act.[370] Essentially, anyone who has obtained more than 5 % of the shares in a company must report this acquisition within ten days to the company, to the stock markets on which the shares are traded, and to the SEC using Form 13D. Once the 5 % threshold has been crossed, every additional share purchase must also be reported using Form 13D, if the purchase significantly changes the number of shares owned by the purchaser.[371] The SEC regards any increase or decrease in a company stake of one percent or more as a significant change; hence, every shift of this kind must be reported.[372] Nevertheless, as explicitly stated by SEC Rule 13d-2b, percentage changes in company stakes do not have to be reported if they are simply the result of a change in the total number of shares (because of increased capital, for instance). Similarly, according to SEC Rule 13d-6, share purchases carried out simply by exercising general options are exempt from the application of Section 13(d) of the 1934 Act. Section 13(d) of the 1934 Act concerns all direct and indirect shareholders. Hence, according to the provisions of SEC Rule 13d-3a, it concerns not only actual shareholders, but also those who, whether through a

366 17 C.F.R. § 240.16a-2(b).

367 17 C.F.R. § 240.16a-2(b).

368 See supra VI. 1.

369 GAF Corp. v. Milstein, 453 F.2d 709, 719 (2d Cir. 1971).

370 Hence, also shareholders in companies with securities traded over the counter but have an actual net worth of more than $10 million and at least 500 shareholders.

371 *Hazen* (N.67), § 11.2(1).

372 *Hazen* (N.67), § 11.2(1).

contract or a sub-contractual agreement, have voting rights, decisional authority regarding voting rights, or authorization to use shares.

SEC Form 13D must be used to fulfill the disclosure obligations provided by Section 13(d) of the 1934 Act. Form 13D requires disclosure of the relevant issuer and security, more specifically, the identity, domicile or headquarters, nationality and background[373] of the individual with reporting obligations.[374] The source and quantity of funds used, the purpose of the transaction and the stake owned by the individual with reporting obligations must be given, as must a representation of the individual's securities transactions in the last 60 days and his or her contracts and agreements relating to the securities. The number of voting rights owned by the individual and his or her percentage stake must also be reported.

Nevertheless, certain institutional investors can use the abridged form, *i. e.*, Form 13G, instead of 13D, if they are obtaining shares as part of their normal commercial activities. Form 13G requires far less to be disclosed than Form 13D. Form 13G merely requires the name and headquarters of the issuer, the name and domicile or headquarters of the individual with reporting obligations, and information regarding the type of institutional investor, if this is the reason why Form 13G is being used, and the quantity of voting rights and shares as percentages, itemized according to whether these are held individually or jointly with other shareholders.

The obligation to report using Form 13D or Form 13G also applies to groups of persons who have agreed to trade jointly in securities.[375] A written agreement is not mandatory:[376] the share purchasing model can be sufficient for the assumption to be made that the individual buyers form a group.[377] In one ruling, for instance, a pause a few percentage points below the 5 % threshold, before this threshold was clearly exceeded, was evaluated as a conscious decision to form a group.[378] Several persons forming a group can either fill in Form 13D or Form 13G together, or they can each fill in a separate form in which they refer to the other group members.

b) Company Stake Disclosure according to Section 13(e) of the 1934 Act

Section 13(d) of the 1934 Act does not apply to repurchases of its own share by an issuer.[379] The immediate disclosure of a company's transactions with its own shares is regulated by Section 13(e) of the 1934 Act. The issuer must report purchases of its own shares separately from its regular reports, either

373 Schedule 13D, Item 2.
374 Schedule 13D, Item 2.
375 Sec. 13(d)(3); *cf.* GAF Corp. v. Milstein, 453 F.2d 709 (2d Cir. 1971).
376 SEC v. Drexel Burnham Lambert Inc., 837 F. Supp. 587 (S.D.N.Y. 1993).
377 Corenco Corp. v. Schiavone & Sons, Inc., 488 F.2d 207 (215) (2d Cir. 1973); Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979).
378 Corenco Corp. v. Schiavone & Sons, Inc., 488 F.2d 207 (215) (2d Cir. 1973).
379 *Steinberg*, Understanding Securities Law, 3rd ed. 2001, § 13. 7.

when a takeover bid is announced[380] or when the company is retreating from the market by purchasing its own shares – in other words, when 1934 Act disclosure obligations do not apply any more.[381] For share purchases on the free market, Form 13E-3 must be submitted at least 30 days before the first relevant share purchase. This disclosure must contain the following: a description of the advantages and disadvantages of the transaction both for the issuer and for the shareholders; comments by an external third party on the transaction; the issuer's plans once the transaction is completed, if they involve a merger, a reorganization or restructuring, or the sale of significant parts of the company; financial information, such as the origin and sum of the funds required for the transaction, a prognosis regarding costs, and an overview of all credit and financing contracts; and a response to the question of whether the transaction is seen as fair to the shareholders not involved, with reasons for this response.[382]

c) Company Stake Disclosure according to Section 16(a) of the 1934 Act

As regards shareholders, the purpose of Section 16(a) is to bolster Section 13(d) and impose disclosure obligations upon persons who can be assumed to have access to insider information because they can influence or control the issuer due to the size of their share holdings.[383] According to Section 16(a) of the 1934 Act, shareholders with 10 % or more of the shares in a company registered with the SEC must inform the SEC within 10 days if they exceed the 10 % threshold. The disclosure obligation in Section 16(a) of the 1934 Act applies only to securities in which the individual with reporting obligations has a direct or indirect financial interest.[384] One can assume an indirect financial interest, for instance, if some of the shares are held by close relatives living in the same household. But one can also assume that stockbrokers, securities traders, investment advisers, investment managers, asset managers and trustees who receive performance-related pay have an indirect financial interest in shares which they hold on behalf of others.[385] The entry report required by Section 16(a) of the 1934 Act if the 10 % threshold is breached must be completed using Form 3, and it must disclose the number of shares and other financial instruments in the company owned by the individuals with reporting obligations.[386] In addition, these individuals must subsequently report every change in their company stake using Form 4 within two working days.[387]

380 Rule 13e-1657; 17 C.F.R. § 240.13e-1; *cf. Hazen* (N.67), § 11.8(1)(A).
381 Rule 13e-3658; 17 C.F.R. § 240.13e-3; *cf. Hazen* (N.67), § 11.8(2)(A).
382 Schedule 13E-3, 17 C.F.R. § 240.13e-100.
383 Sec. Exch. Act Rel. No. 34-28869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) 84,709 (Feb. 8, 1991).
384 Rule 16a-1(a)(2).
385 Rule 16a-1(a)(2)(ii).
386 17 C.F.R. § 240.16a-3(f); 17 C.F.R. § 240.16a-6(a); Sec. 403 (a) Public Company Accounting Reform and Investor Protection Act.
387 17 C.F.R. § 240.16b-5.

VII. Conclusion

The analysis above illustrates that the disclosure requirements *vis-à-vis* companies in the U.S. are rather extensive and subject to detailed regulations. The detailed provisions of the 1933 Act, the 1934 Act and the Sarbanes-Oxley Act, in connection with the rules and regulations promulgated by the SEC, as well as the extensive scope for monitoring, control, and sanctions, along with the case law in respect of various anti-fraud provisions ensure that the business activities of publicly-held companies are transparent to investors or potential investors. Thus, the investor or, rather, all market participants are furnished with material information of relevance to investment decisions. The study of the disclosure requirements in the U.S. reveals that the extensive information requirements cannot be regarded as a paternalistic relationship, as European legislators should bear in mind when implementing or rather taking on the information requirements as practiced in the U.S. Justice *Brandeis* emphasized that although the securities laws should ensure the provision of valid information to shareholders, the analysis of such data is the responsibility of investors.[388] His remark on the parallels to the pure food laws illustrates the principle: "It does not guarantee quality or prices, but it does help consumers to judge quality by requiring the disclosure of ingredients."[389] This fundamental attitude is manifested time and again in court decisions in the U.S., for instance when uncertain information in respect of future developments, such as the commencement of negotiations prior to a merger, is asked for emphatically in spite of the risk of problems in processing such information on the part of the audience. As the courts typically assume semi-efficient capital markets, the logical consequence would be that the threat of having the products of erroneous information analysis on the part of a few investors is not taken into account compared to the larger quantity of publicly available information, which is represented appropriately in the stock price by definition. In this sense it can be assumed that the (indirect, informational) protection of investors is improved if more information is contained within the share prices. There is no reason to assume that this principle is only valid in the U.S. Therefore, the introduction of new and/or more detailed information requirements in both the U.S. and Europe is to be expected in the future.

388 *Brandeis* (N.55), p. 70: "[...] it should not seek to prevent investors from making bad bargains. But it is now recognized in the simplest merchandising that there should be full disclosures".

389 *Brandeis* (N.55), p. 70.