A SIGNAL FOR HONEST MANAGEMENT FORECASTS: EXPANDING THE PSLRA SAFE HARBOR TO IPO ISSUERS WITH EXTENDED LOCKUP PERIODS

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ABSTRACT

This article seeks to address one of the initial public offering ("IPO") market's most intractable problems: how to reduce the information asymmetry between IPO issuers and potential investors regarding the firm's future financial performance. Valuing IPO stock fundamentally requires projecting the IPO issuer's future performance, yet IPO issuers almost never voluntarily publish their internal financial forecasts ("management forecasts") in their IPO disclosure documents due to liability concerns. Federal law could reduce those liability concerns by immunizing IPO issuers' management forecasts from private litigation.

The Private Securities Litigation Reform Act (the "PSLRA") already provides such immunization for seasoned public companies through a forward-looking statements safe harbor (the "PSLRA Safe Harbor"), but the safe harbor expressly excludes IPOs from its protections. Immunizing IPO issuers from management-forecast liability is not problem free. It could encourage IPO issuers to publish exaggerated forecasts that would exacerbate, rather than reduce, information asymmetries. Thus, the PSLRA Safe Harbor should only be expanded to protect IPO issuers if such expansion can be designed in a way that allows investors to easily distinguish honest management forecasts from dishonest ones.

This article provides such a solution and argues for expanding the PSLRA Safe Harbor's protections to IPO issuers that submit to extended lockups. Lockups are private contracts between the underwriters and the IPO issuer's most important stockholders ("Insiders") that prevent the Insiders from selling their shares for a period following the IPO. Applying signaling theory, this article explains how properly designed extended lockups signal that an IPO issuer is an honest forecaster that produces conservative forecasts. Such honest-forecasting IPO issuers are worthy of the PSLRA Safe Harbor's immunity protections, which would allow them to reduce their information asymmetries and improve the overall efficiency of the U.S. IPO market

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TABLE OF CONTENTS

INTRODUCTION

Federal securities law should be amended to make it easier for issuers to disclose management forecasts when conducting a traditional initial public offering (an "IPO"). Management forecasts—which include projections for future revenues, costs, earnings, earnings-per-share, and other financial information—are critical to valuing IPO stock, yet IPO issuers almost never include them in their IPO disclosure documents due to liability concerns.[1] The Private Securities Litigation Reform Act of 1995 (the "PSLRA")[2] largely alleviates the liability concerns for issuers that are already public companies through a forward-looking statements safe harbor (the "PSLRA Safe Harbor").[3] However, the PSLRA Safe Harbor explicitly excludes forward-looking statements made in connection with IPOs from its protections.[4] This article argues for expanding the PSLRA Safe Harbor's protections to IPO issuers that submit to extended lockup periods.

Valuing stock fundamentally requires projecting the issuer's future financial performance. A stock's value stems from the issuer's ability to generate future cash flows.[5] Future cash flow potential is so important because it provides guidance on the issuer's ability to pay dividends and accumulate net cash that can eventually be distributed to stockholders upon

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[1] Spencer Feldman, *Growth Companies Should Disclose Financial Projections In IPO Prospectuses*, OLSHAN LAW: SECURITIES LAW BLOG (Apr. 9, 2021), https://www.olshanlaw.com/blogs-Securities-Law-Blog,growth-cos-should-disclose-projections-in-ipo ("Based on our review of IPO filings over the past three years, no IPO company has actually provided financial projections, other than vague narrative disclosure in response to the SEC's management discussion and analysis rules regarding trends in liquidity and financial condition."); George Casey *et al.*, *SEC Considering Heightened Scrutiny of Projections in De-SPAC Transactions*, SHEARMAN & STERLING: PERSPECTIVES (Apr. 30, 2021), https://www.shearman.com/Perspectives/2021/04/SEC-Considers-Heightened-Scrutiny-of-Projections-in-De-SPAC-Deals (". . . projections are not typically included in initial public offering (IPO) disclosures.").

[2] Private Securities Litigation Reform Act Preamble, Pub. L. 104-67, 109 Stat. 737 (1995).

[3] The PSLRA Safe Harbor is codified in § 27A of the Securities Act of 1933 (the "Securities Act"), 15 U.S.C. § 77z-2, and § 21E of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78u-5.

[4] Securities Act § 27A(b)(2)(D), 15 U.S.C. § 77z-2(b)(2)(D); Exchange Act § 21E(b)(2)(D), 15 U.S.C. § 78u-5(b)(2)(D).

[5] JANET KIHOLM SMITH, RICHARD L. SMITH & RICHARD T. BLISS, ENTREPRENEURIAL FINANCE: STRATEGY, VALUATION & DEAL STRUCTURE 342 (2011).

liquidation.[6] It is not an overstatement to say that reasonable forecasts are the *sine qua non* for thoughtfully valuing stock, including IPO stock. While investors can develop their own forecasts, doing so for IPO issuers is particularly difficult since they usually involve younger companies with limited track records and highly uncertain futures. IPO issuers could reduce this information asymmetry by voluntarily disclosing management forecasts, but as noted above, few do so for fear of being sued if they fail to achieve the projected results.

Forecasts are not concrete, verifiable facts. They are subjective predictions of an uncertain future. They require choosing a limited number of possible outcomes from a distribution of possibilities. "The greater the uncertainty, the wider the distribution of possibilities,"[7] and the more challenging it is to produce perfectly accurate forecasts. While inaccurate forecasts are not themselves actionable, materially misleading or fraudulent forecasts are. Differentiating between the two can be difficult, which opens the door for stockholder strike suits[8] as hindsight bias may cloud a court's view of the inaccurate forecasts.

Recognizing investors' need for management forecasts and the litigation threat they pose, Congress adopted the PSLRA Safe Harbor in 1995. The PSLRA Safe Harbor—which is codified as section 27A[9] of the Securities Act of 1933[10] (the "Securities Act") and section 21E[11] of the Securities Exchange Act of 1934[12] (the "Exchange Act") — generally provides that a person is not liable in a private action for a forward-looking statement if the statement is (a) identified as a forward-looking statement and accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially,[13] (b) immaterial,[14] or (c) not made with actual knowledge the statement was false or misleading.[15] With the PSLRA Safe Harbor, Congress sought to do more than just permit issuers to disclose management forecasts; the

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[6] *See* discussion *infra* Part I.A.
[7] PAUL A. GOMPERS & JOSH LERNER, THE MONEY OF INVENTION: HOW VENTURE CAPITAL CREATES NEW WEALTH 23 (2001).
[8] A "stockholder strike suit" is a lawsuit brought by a minority of stockholders against a corporation that is of questionable merit but expensive to defend. Even if the plaintiffs' case is not particularly strong, they may be motivated to bring the case to seek a settlement value that is greater than the cost to bring the case but less than the cost to defendant it. Because paying the settlement is cheaper than defending the case, the defendant may agree to pay the settlement.
[9] 15 U.S.C. § 77z-2.
[10] 15 U.S.C. § 77a *et seq.* [hereinafter Securities Act].
[11] 15 U.S.C. § 78u-5.
[12] 15 U.S.C. § 78a *et seq.* [hereinafter Exchange Act].
[13] Securities Act § 27A(c)(1)(A)(i), 15 U.S.C. § 77z-2(c)(1)(A)(i); Exchange Act § 21E(c)(1)(A)(i), 15 U.S.C. § 78u-5 (c)(1)(A)(i).
[14] Securities Act § 27A(c)(1)(A)(ii), 15 U.S.C. § 77z-2(c)(1)(A)(ii); Exchange Act § 21E(c)(1)(A)(ii), 15 U.S.C. § 78u-5(c)(1)(A)(ii).
[15] Securities Act § 27A(c)(1)(B), 15 U.S.C. § 77z-2(c)(1)(B); Exchange Act § 21E(c)(1)(B), 15 U.S.C. § 78u-5(c)(1)(B).

legislative history strongly suggests Congress actively sought to encourage such forecasts.[16]

One of federal securities law's most important functions is to improve market efficiency by reducing information asymmetries between issuers and investors. Issuers almost always have better information than investors about the positives and risks involved with investing in their companies, and this is particularly true for forecasts. Managements forecasts can provide investors with valuable information, but they "can also be untested, speculative, misleading or even fraudulent."[17] "Insiders have an incentive to exaggerate the issuer's performance and prospects, and investors can't directly verify the information that the issuer provides."[18] The PSLRA Safe Harbor seeks to balance the pros and cons of issuer forecasts by limiting its protections to "seasoned issuers" with an "established track-record."[19] If investors can differentiate honest versus dishonest issuers, they can use that information when deciding how much weight to give to management forecasts. Seasoned issuers have a disclosure track record and can build trust in the quality of their disclosures that allows investors to differentiate honest issuers that make high-quality disclosures from unreliable issuers. Because IPO issuers lack disclosure track records, IPOs are excluded from the PSLRA Safe Harbor protections.

Congress though, did not foreclose the possibility of someday expanding the PSLRA Safe Harbor to cover IPOs. When Congress adopted the PSLRA Safe Harbor in 1995, it authorized the Securities and Exchange Commission (the "SEC") to revisit the IPO question in the future.[20] The SEC did so in 2004 and 2005 as part of a broad set of offering reforms.[21]

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[16] *See generally* H.R. REP. NO. 104-369, at 43 (1995) (Conf. Rep.) [hereinafter PSLRA Conf. Rep.] (Congress adopted the PSLRA Safe Harbor to "enhance market efficiency by encouraging companies to disclose forward-looking information.").
[17] John Coates, *SPACs, IPOs and Liability Risk under the Securities Laws*, SEC PUBLIC STATEMENTS (Apr. 8, 2021), https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws. John Coates was the former acting Director of the Division of Corporate Finance at the SEC.
[18] Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 BUS. LAW. 1565, 1567 (2000).
[19] *See* 141 CONG. REC. S19062 (daily ed. Dec. 21, 1995) (statement of Sen. Diane Feinstein) ("I . . . understand the safe harbor provisions do not apply to certain companies we may have reason to have some doubt about, such as penny stock companies, initial public offerings known as IPO's, blank check companies, roll-up transactions, or companies recently convicted of specific securities law violations. All of these types of companies are excluded, as I understand it, from the protection of the safe harbor provisions. The provisions are only available to companies with an established track record . . . I understand the safe harbor does not apply to a new company, but only applies to seasoned issuers"). *See also* Coates, *supra* note 17.
[20] Securities Act § 27A(b), 15 U.S.C. § 77z-2(b); Exchange Act § 21E(b), 15 U.S.C. § 78u-5(b).
[21] Proposed Rule, Securities Offering Reform, Securities Act Release No. 8501, Exchange Act Release No. 50624, Investment Company Act Release No. 26649 *23 [hereinafter Release No. 33-8501]; Final Rule, Securities Offering Reform, Securities Act Release No.

However, the SEC chose not to extend the Safe Harbor to IPOs at that time, expressing again its concern that IPO issuers are generally untested, so investors have a "limited basis to assess the reasonableness of assumptions underlying the projections about the issuer's business."[22] Expanding the PSLRA Safe Harbor to cover IPOs could embolden issuers to publish overly aggressive forecasts that public investors are not well-equipped to evaluate, thus increasing information asymmetries and promoting over-priced IPOs.

This article explains how extended lockups can be used to address SEC concerns and incentivize honest, conservative forecasts from IPO issuers. Lockups are private contracts between the underwriters and the IPO issuer's most important stockholders—typically its directors and officers, any selling stockholders, and its large stockholders (collectively, "Insiders")—that prevent the Insiders from selling their shares for a period following the IPO.[23] Issuers could use extended lockup periods as a signal for their honesty. An extended lockup period would cause the Insiders to remain committed to the issuer until a meaningful interval of actual results have been revealed, making a hostage of their locked-up wealth. If the issuer's post-IPO performance does not align with the forecasts during the lockup period, public investors could sell their shares, thus lowering the issuer's stock price and causing the Insiders a loss.

The standard IPO lockup period is six months,[24] which means that only three months of results are revealed before Insiders can typically sell their shares. Because it is easy to manage forecasts to meet three months of expectations, the standard IPO lockup period is unlikely to discourage aggressive forecasts and is not an effective signal. However, if the lockup period requires Insiders to hold the issuer's shares for an extended period—such as until a full year of results are revealed—the IPO issuer and its Insiders have a powerful incentive to produce conservative projections for at least one year. Insiders' willingness to make such an extended commitment provides a credible signal that the IPO issuer is furnishing good faith projections. As a result, this article suggests expanding the PSLRA Safe Harbor's protections to IPO issuers that submit to extended stockholder lockups that generally require selected Insiders to refrain from selling their shares until the issuer has published a full year of actual results.

8591, Exchange Act Release No. 52056, Investment Company Act Release No. 26993 *30 [hereinafter Release No. 33-8591].

[22] *Id.*

[23] *See* discussion *infra* Part IV.B.1.

[24] *Understanding Lock-Up Agreements*, PRACTICAL LAW CORPORATE & SECURITIES, Westlaw W-015-3236 (last visited Aug. 30, 2022) [hereinafter *Understanding Lock-Up Agreements*]; Anna Pinedo & Ryan Castillo, *Top 10 Practice Tips: Lock-Up Agreements*, LEXIS PRACTICE ADVISOR, 1 (2020) https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/09/top-10-practice-tips-lockup-agreements.pdf.

This issue of IPO-issuer forecasts is ripe for consideration. IPOs have long been the dominant method for private companies to go public.[25] With a traditional IPO, a private company sells its common stock to the public through one or more investment banks and lists the stock on a stock market.[26] During 2020 and 2021, however, a surge of special purpose acquisition company ("SPAC") transactions resulted in SPAC IPOs outpacing traditional IPOs.[27] SPAC IPOs differ substantially from traditional IPOs. A SPAC is a shell company created "to raise capital in an IPO solely in anticipation of identifying and acquiring an existing private company."[28] The private-company acquisition, commonly referred to as a "de-SPAC transaction,"[29] takes place through a business combination. If successful, the de-SPAC allows the private company to become a reporting company with publicly traded shares without having to conduct a traditional IPO.[30] One oft cited benefit for choosing the SPAC route "is the ability to directly communicate financial projections to the market"[31] when conducting the de-SPAC business combination.[32] The private company in the de-SPAC transaction is allowed to undertake a transaction that is roughly equivalent to a traditional IPO while publishing forecasts that may be protected by the PSLRA Safe Harbor. The use of projections in de-

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[25] *Top Ways to List*, N.Y. STOCK EXCH., https://www.nyse.com/ways-to-list (last visited Sep. 17, 2022).

[26] *See e.g.*, *Investor Bulletin: Investing in an IPO*, SEC OFF. OF INV. EDUC. & ADVOC., https://www.sec.gov/files/ipo-investorbulletin.pdf; *Important Information about Initial Public Offerings*, ROBERT W. BAIRD & CO. INC. (2021), https://content.rwbaird.com/RWB/Content/PDF/Help/Important-information-about-IPOs.pdf.

[27] Per Statista, SPAC IPOs accounted for 53 percent of the U.S. IPOs conducted in 2020 and 58 percent in 2021. *Distribution of traditional IPOs and special purpose acquisition company (SPAC) IPOs in the United States from 2016 to 2021*, STATISTA (July 4, 2022), https://www.statista.com/statistics/1234111/number-traditional-spac-ipo-usa/.

[28] Jay L. Pomerantz et al., *Financial Projections in SPAC Transactions: Mitigating Class Action Litigation Risk*, FENWICK (Oct. 12, 2020), https://www.fenwick.com/insights/publications/financial-projections-in-spac-transactions-mitigating-class-action-litigation-risk.

[29] *Id.*; Coates, *supra* note 17.

[30] If the SPAC is unable to identify a target and complete the acquisition within the set time period, the SPAC liquidates and returns the trust account funds to its stockholders.

[31] Jay Pomerantz et al., *Fenwick & West Discusses Mitigating Class Action Litigation Risk for SPAC Transactions*, THE CLS BLUE SKY BLOG (Oct. 26, 2020), https://clsbluesky.law.columbia.edu/2020/10/26/fenwick-west-discusses-mitigating-class-action-litigation-risk-for-spac-transactions/.

[32] On March 30, 2022, the SEC issued proposed rules to enhance disclosure and investor protection relating to SPACs, shell companies, and projections. Proposed Rules, Special Purpose Acquisition Companies, Shell Companies, and Projections, Securities Act Release No. 11048, Exchange Act Release No. 94546, Investment Company Act Release No. 34549 [hereinafter Release No. 33-11048]. In a press release, the SEC explained that, if adopted, "the new rules would address issues relating to projections made by SPACs and their target companies, including the Private Securities Litigation Reform Act safe harbor for forward-looking statements and the use of projections in Commission filings and in business combination transactions." *SEC Proposes Rules to Enhance Disclosure and Investor Protection Relating to Special Purpose Acquisition Companies, Shell Companies, and Projections*, SEC PRESS RELEASE (Mar. 30, 2022), https://www.sec.gov/news/press-release/2022-56.

SPACs has drawn considerable attention from academics,[33] the SEC,[34] and even Congress.[35] While SPACs have garnered substantial attention, the more fundamental question is whether forecasts can be rendered suitably safe for traditional IPOs, and this author believes they can be.

This article proceeds as follows: Part I explains forecasts' role in valuing stock and why they are essential to thoughtful IPO investing and an efficient IPO market. Part II explores the liability challenges that forecasts present for IPO issuers and their investors. Part III explains why the current version of the PSLRA Safe Harbor is not ideal for issuers without a track record of publicly disclosed information. The PSLRA Safe Harbor is premised on investors being able to differentiate honest forecasters from dishonest forecasters, which they can do for seasoned issuers based on such issuers' disclosure reputation. If the PSLRA Safe Harbor is to be expanded to include IPOs, investors will need an alternative mechanism for identifying IPO issuers that are honest forecasters. Part IV examines signaling theory and how it can be used to identify such honest IPO issuers that are worthy of PSLRA-Safe-Harbor protection. Specifically, Part IV explains how extended lockups can be designed to serve as a credible signal for IPO issuers that are honest forecasters. Finally, Part V offers a conclusion.

I. VALUATION, FORECASTS, AND INFORMATION ASYMMETRIES

An IPO marks an issuer's introduction to the United States' public securities markets. Traditional IPOs, which are this article's focus, have the following principal features: (a) the issuer sells its common stock to the public; (b) the public sale takes place through a firm-commitment,[36] underwritten offering conducted by a group of investment banks; and (c) the public offering is accompanied with a listing of the company's stock on a prominent stock market (such as the New York Stock Exchange or NASDAQ) to create a liquid secondary market for the stock.[37] When the IPO is done, the issuer has publicly traded stock and is an Exchange Act reporting company.[38] No law states an IPO must involve common stock. A company can conduct an IPO by issuing debt securities or by offering some form of preferred stock. However, common stock happens to be the

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[33] *See, e.g.*, Amanda Rose, *SPAC Mergers, IPOs, and the PSLRA's Safe Harbor: Unpacking Claims of Regulatory Arbitrage*, 64 WM. & MARY L. REV. __ (forthcoming, 2022).
[34] Release No. 33-11048, *supra* note 32.
[35] On November 16, 2021, the House Financial Services Committee introduced a bill referred to as the Holding SPACs Accountable Act of 2021, H.R. 5910, 117th Cong. § 1 (2021), that would remove de-SPAC projections from the PSLRA Safe Harbor's protections.
[36] With a firm commitment underwriting, the underwriters contractually commit to purchase all the securities offered in the offering. The underwriters then immediately resell those securities to the public.
[37] *See e.g.*, SEC OFF. OF INV. EDUC. & ADVOC., *supra* note 26; ROBERT W. BAIRD & CO., *supra* note 26.
[38] Exchange Act § 12, 15 U.S.C. § 78l, or Exchange Act § 15(d), 15 U.S.C. § 78o(d).

dominant IPO security, so this article focuses on investors' ability to value common stock.

A. Valuing Common Stock

A valuation analysis seeks to determine an asset's value, which begs the question: what does "value" mean? Value is the measure of the future benefits an asset is expected to generate for its holder.[39] In the case of financial instruments, such as common stock, the benefits they provide to holders are future cash flows. Reasonable investors acquire financial instruments "for the cash flows expected on them."[40] The value of a financial instrument, therefore, is the present value of those future cash flows.[41]

How does common stock generate cash flow for stockholders? Owning stock entitles the stockholders to several rights and benefits, the most important of which is their right to the corporation's residual (see Figure 1).[42] A corporation's residual is its net assets after accounting for liabilities owed. Assuming a typical form of common stock, stockholders generally receive two economic rights from their stock, both of which relate to the corporation's residual.

1. **Dividends.** If the corporation has a positive residual, it may distribute a portion of the residual to stockholders through dividends.[43]
2. **Liquidation distribution.** If the corporation is liquidated, its stockholders share equally in the corporation's final residual after all its liabilities have been satisfied.[44]

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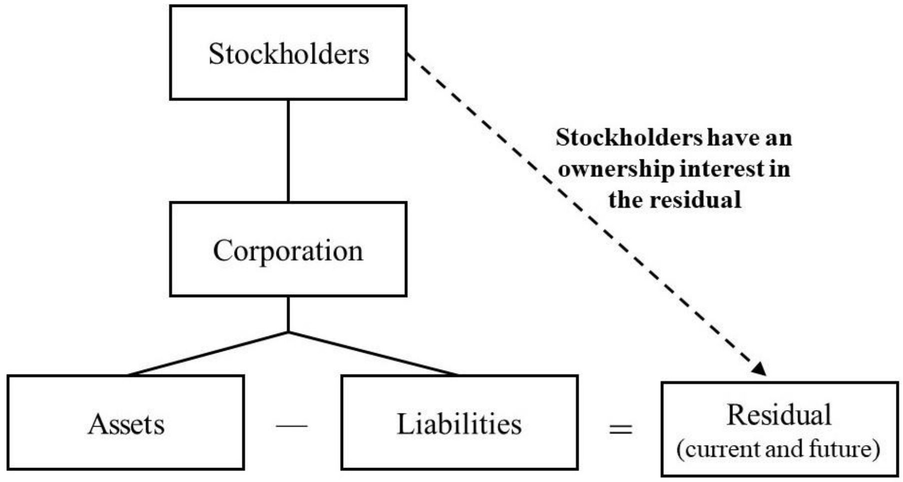
[39] WILLIAM J. MURPHY, JOHN L. ORCUTT & PAUL C. REMUS, PATENT VALUATION: IMPROVING DECISION MAKING THROUGH ANALYSIS 5 (2012).
[40] ASWATH DAMODARAN, INVESTMENT VALUATION: TOOLS AND TECHNIQUES FOR DETERMINING THE VALUE OF ANY ASSET 1 (U. ed., 3d ed. 2012) [hereinafter INVESTMENT VALUATION].
[41] SMITH et al., *supra* note 5, at 342.
[42] *See, e.g.,* DEL. CODE ANN. TIT. 8, § 281(a)–(b).
[43] *See, e.g.,* DEL. CODE ANN. TIT. 8 § 170.
[44] *See, e.g.,* DEL. CODE ANN. TIT. 8 § 281(a)–(b).

Figure 1:
A Corporation's Residual



If the corporation has multiple classes of stock (e.g., common and preferred stock), the stockholders' residual rights can be more complex. Priorities and mandatory payments must be accounted for. However, the fundamental concept remains the same. The stockholders have rights to the corporation's residual, which they collect through dividends and a final liquidation distribution.

The value of a share of common stock, therefore, should reflect the present value of the future dividends and liquidation distributions it projects to generate for a stockholder.[45] Predicting those future payments fundamentally requires forecasting the company's future cash flows and assessing the risk associated with this future performance.[46]

There are many specific techniques for valuing an IPO issuer's stock, each with its own nuances. The underlying concept, however, is constant: the stock's intrinsic value is equal to the present value of its future cash flows, using a discount rate that accounts for the time value of money and the uncertainty associated with the forecasts.[47] Some valuation techniques explicitly calculate the present value of the projected cash flows (e.g., a

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[45] What about investors who sell their shares before the corporation liquidates? While they do not receive all the dividends or the liquidation distribution, they are not left empty-handed. SMITH et al., *supra* note 5, at 353. They receive a lump-sum payment when they sell their shares that should approximate the value of the post-sale dividends and liquidation distribution. *See id*. Thus, even when an investor intends to resell its common stock before liquidation, the stock's value should reflect the present value of all the future dividends plus the share of the liquidation distribution associated with the stock.
[46] ASWATH DAMODARAN, THE DARK SIDE OF VALUATION: VALUING YOUNG, DISTRESSED, AND COMPLEX BUSINESSES 29 (3d ed. 2018) [hereinafter DARK SIDE OF VALUATION].
[47] *Id*.

discounted cash flow analysis[48]), while others try to indirectly infer that value (e.g., a relative value method, such as a price-to-earnings ratio analysis[49]). However, regardless of the technique used, a thoughtful valuation analysis cannot be accomplished without reasonable forecasts of the issuer's future financial performance.

B. Forecasts

Like any data-driven exercise, valuation analysis is subject to the *garbage in, garbage out* principle.[50] "[T]he quality of the analysis is entirely dependent on the quality of the inputs that are used in the calculation."[51] A valuation analysis involves three steps:

- Step 1: Gather information.
- Step 2: Run the information through a legitimate valuation technique (e.g., a discounted cash flow analysis or a price-to-earnings ratio analysis).
- Step 3: Interpret the results.[52]

When valuation is discussed, there is a tendency to focus on the techniques. However, each technique depends on the quality of the information feeding the model, "If the inputs are substantially wrong, the answer that comes from the [valuation] analysis will [also] be substantially wrong."[53] If prospective investors struggle to develop reasonable forecasts, they will struggle to develop reasonable valuations, thereby leading to a less efficient IPO market.

1. Developing the Forecasts

Developing reasonable forecasts may be the most challenging task for valuing a company. It requires understanding things such as:

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48 The basic DCF formula is:

$$Value = \frac{CF_1}{1+r} + \frac{CF_2}{(1+r)^2} + \frac{CF_3}{(1+r)^3} + \ \dots \ \frac{CF_n}{(1+r)^n}$$

where

CF	= cash flow
$CF_{1,2,3,\ etc.}$	= the subscript refers to the period when the future cash flows are generated
n	= last period cash flows are to be received
r	= discount rate

ASWATH DAMODARAN, DAMODARAN ON VALUATION: SECURITY ANALYSIS FOR INVESTMENT AND CORPORATE FINANCE 10 (2d ed. 2006) [hereinafter DAMODARAN ON VALUATION]; DARK SIDE OF VALUATION, *supra* note 46, at 29. There are many variations of the DCF model. INVESTMENT VALUATION, *supra* note 40, at 12. However, the basic approach is consistent between all of them: project the investment's cash flows by period and apply a discount rate to determine its present value.

49 *See id.* at 453–467.

50 *See* MURPHY et al., *supra* note 39, at 131.

51 *See id.*

52 *See id.* at 67.

53 *Id.* at 131.

- The current and future markets for the company's products or services;
- The company's ability (and desire) to pursue such opportunities (e.g., product/service quality, management strength, supplier relationships, access to resources, and the company's ability to adapt to changes);
- The competitive landscape for the company's market opportunities; and
- The macroeconomic environment.[54]

With this type of knowledge, one can build financial models for the issuer's future performance.

Valuers commonly employ several approaches for developing forecasts. This article briefly considers three of the more popular approaches: (1) historical track record; (2) management estimates; and (3) analyst estimates.[55]

a. Historical Track Record

A common technique for developing forecasts is to extrapolate future performance from the issuer's past performance.[56] Sometimes referred to as trend analysis or time-series analysis, the valuer looks behind to see forward.[57] The valuer uses a regression model based on the issuer's past results or a combination of past results and other financial variables or information.[58] While past performance is no guarantee for the future, a firm's history is often viewed as "the most logical source"[59] for building estimates for the issuer's future performance. Forecasts are easiest to extrapolate from past performance when there is a considerable track record for that past performance. It is easier to project future sales, costs, and earnings for Apple iPhones than it is to project the future performance for the kind of emerging technologies or emerging business models that tend to be associated with IPO issuers.[60] This does not mean that investors cannot use an IPO issuer's historical track record to formulate their own forecasts, but the task is usually harder than for seasoned, public companies and involves more uncertainty.

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[54] John L. Orcutt, *Valuing Young Startups is Unavoidably Difficult: Using (and Misusing) Deferred-Equity Instruments for Seed Investing*, 55 TULSA L.R. 469, 486 (2020).
[55] *See* DAMODARAN ON VALUATION, *supra* note 48, at 117.
[56] *See id.* at 120–24. *See also* MURPHY et al., *supra* note 39, at 139.
[57] *See* MURPHY et al., *supra* note 39, at 139.
[58] Vitor Azevedo, Patrick Bielstein & Manuel Gerhart, *Earnings Forecasts: The Case for Combining Analysts' Estimates With a Cross-Sectional Model*, 56 REV. QUANT. FIN. ACCOUNT. 545, 546 (2020).
[59] DAMODARAN ON VALUATION, *supra* note 48, at 120.
[60] *See* Orcutt, *supra* note 54, at 487.

b. Management Estimates

Valuers often use forecasts provided by the issuer's management in their valuation models.[61] For example, valuers regularly use management forecasts as a starting point for their financial performance estimates and adjust the management forecasts based on the valuer's views of the issuer. Valuers' use of management forecasts is not surprising. The issuer's management should have better information for developing forecasts than most outsiders. Managers do have better information "about the inner workings of the firm—cash flows on projects, trends in inventory, profit margins on individual items—that are unavailable to outside investors."[62] Moreover, "managers . . . control some of the levers that determine growth, since they are the ones who decide on how much new investment to make and in what areas."[63]

While managers have an important information advantage, they are also biased and have incentives to generate self-serving forecasts. They "have an incentive to present their firms (and by extension, themselves) in the best positive light."[64] This bias can present itself differently for private firms, including IPO issuers, and publicly traded firms. Aswath Damodaran (commonly referred to as the "Dean of Valuation"[65]) explains:

> With private firms interested in raising capital, the forecasts of future growth will not only be optimistic but will be accompanied by equally optimistic estimates of the quality of the growth. With publicly traded firms, it is a more delicate dance, since markets react to earnings surprises—the differences between actual and expected earnings. It is conceivable that managers may try to talk down expectations about earnings, at least in the short term, so that they can deliver positive earnings surprises.[66]

Since this article focuses on IPO issuers, the relevant concern is management over-optimism.

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[61] *See* DAMODARAN ON VALUATION, *supra* note 48, at 124.
[62] Aswath Damodaran, *Growth and Value: Past Growth, Predicted Growth and Fundamental Growth* 24 (N.Y.U. Stern Sch. of Bus. Working Paper, 2008), https://pages.stern.nyu.edu/~adamodar/pdfiles/papers/growthorigins.pdf [hereinafter *Growth and Value*].
[63] *Id*.
[64] *Id*. at 25.
[65] *See, e.g.*, Kevin Harris, *Professor Aswath Damodaran on Valuation*, FORBES (July 17, 2018), https://www.forbes.com/sites/kevinharris/2018/07/17/professor-aswath-damodaran-on-valuation/?sh=60e3ca13722c; Kevin Stankiewicz, *NYU's 'Dean of Valuation' says driving stock price up won't make GameStop's fundamental problems go away*, CNBC (Jan. 28, 2021, 4:43 PM), https://www.cnbc.com/2021/01/28/nyus-dean-of-valuation-aswath-damodaran-on-gamestop-amc-business-problems.html.
[66] *Growth and Value*, *supra* note 62, at 25.

c. Analyst Estimates

Forecasts by equity research analysts ("analysts") are the third common source[67] of valuation-model forecasts that this article considers. Analysts conduct research and produce reports to assist investors with their stock decisions.[68] Analysts gather information (both public and private) about issuers, their industries, and their competitors, and the analysts use this information to develop models for the issuers' future financial performance.[69] Analysts have the potential to be some of the market's best informed actors about a given stock, and they are the "most common source of expected earnings growth rates"[70] for publicly traded firms. Analyst forecasts tend to be "fairly accurate," but research has also shown a "significant optimism bias."[71]

Analyst forecasts are the focus of an extensive amount of academic research. However, a few generalizations can be drawn about analyst forecasts that are relevant for this article.

- **Forecast horizon.** The forecast horizon is the future time period covered by an analyst's forecasts. Analysts generate forecasts with horizons "ranging from the quarter ahead to five years forward."[72] However, analysts are more likely to generate short-term forecasts (e.g., two years or less) than long-term forecasts.[73] Analyst forecasting tends to be more accurate for shorter horizons and less accurate for longer horizons.[74] There are several explanations for forecasting accuracy decreasing over time, including the simple fact that a longer time period introduces more uncertainty to the exercise. Additionally, analysts suffer less reputational risk for forecasting inaccuracies at longer horizons.[75]
- **Frequent adjustments.** Analysts frequently update their earnings estimates.[76] Studies have found that analysts typically start the year by over-estimating current-year

[67] DAMODARAN ON VALUATION, *supra* note 48, at 124–25.
[68] John L. Orcutt, *Investor Skepticism v. Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors*, 81 DENV. U.L. REV. 1, 6-10 (2003).
[69] *See id.* at 49.
[70] *Growth and Value*, *supra* note 62, at 20.
[71] Azevedo et al., *supra* note 58, at 546.
[72] *Growth and Value*, *supra* note 62, at 20.
[73] *See id*.
[74] *See, e.g.*, Charles G. Ham et al., *Rationalizing Forecast Inefficiency*, 27 REV. ACCOUNT. STUD. 313 (2022).
[75] *Id.* at 314 (2022) ("forecast inaccuracy exposes analysts to greater reputational risk at shorter horizons").
[76] *Growth and Value*, *supra* note 62, at 21.

earnings, then adjusting the estimates downwards towards actual earnings throughout the year.[77]

- **Number of analysts.** Some issuers are followed by lots of analysts, while others are followed by a few analysts, one analyst, or even no analysts. Studies have shown that forecast accuracy increases with a greater analyst following.[78]

2. Forecast Sources for IPOs

Better forecasts lead to better valuations, which lead to a more efficient securities market. Not surprisingly, a large body of research has been dedicated to forecast accuracy. Do analyst forecasts outperform forecasts based on time-series models? Do management forecasts outperform analyst forecasts? What factors improve forecasts, and what factors are more likely to cause errors? Much of the research focuses on achieving incremental improvements to forecast accuracy.

For IPO investors, the most important forecasting problem is not achieving such incremental improvements. Their main concern is simply obtaining reasonable forecasts. Historical-track-record forecasts are not ideal since IPO issuers usually involve younger companies with limited track records and highly uncertain futures. Analysts could fill the gap with their forecasts, but they generally do not do so until several weeks after the IPO is complete.[79] The reason for analysts delaying their forecasts is nuanced. Federal securities law[80] and FINRA regulations govern analyst research before and after an IPO is completed. FINRA,[81] which stands for

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[77] Vijar Kumar Chopra, *Why So Much Error in Analysts' Earnings Forecasts?* 54 FIN. ANALYSTS J. 35, 36 (1998); *See also* Scott Richardson, Siew Hong Teoh & Peter D. Wysocki, *Tracking Analysts' Forecasts over the Annual Earnings Horizon: Are Analysts' Forecasts Optimistic or Pessimistic?* 1, 28–29 (Univ. of Mich. Bus. Sch., Working Paper, 1999), https://ssrn.com/abstract=168191.

[78] *See e.g.,* Andrew W. Alford & Philip G. Berger, *A Simultaneous Equations Analysis of Forecast Accuracy, Analyst Following, and Trading Volume*, 14 J. ACCT. AUDIT. FIN. 219, 220 (1999).

[79] Chunxin Jia, Jay R. Ritter, Zhen Xie & Donghang Zhang, *Pre-IPO Analyst Coverage: Hype or Information Problem?* 2 (August 2019) (unpublished working paper) (available at https://site.warrington.ufl.edu/ritter/files/2019/08/China_IPOs_August2019_for_posting.pdf).

[80] The Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, 791 (2002) – includes a section 501, which has been codified as Exchange Act § 15D, 15 U.S.C. § 78o-6. Section 15D required the SEC directly, or through "a registered securities association" (i.e., FINRA) or "national securities exchange," to adopt "rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances . . . ." Exchange Act § 15D(a), 15 U.S.C. § 78o-6(a). FINRA, Rule 2241 is a result of that rule-making process.

[81] FINRA was created in 2007 when the National Association of Securities Dealers was consolidated with "the member regulation, enforcement, and arbitration operations of the New York Stock Exchange." Nancy Condon & Herb Perone, *NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority—FINRA*, FINRA NEWS RELEASE, (Jul. 30, 2007), https://www.finra.org/media-center/news-releases/2007/nasd-and-nyse-member-regulation-combine-form-financial-industry.

the Financial Industry Regulatory Authority, is not a government agency but instead is a self-regulatory national securities association that operates under the purview of the SEC.[82] FINRA oversees "every broker and brokerage firm doing business with the U.S. public"[83] ("member firms"). FINRA Rule 2241 imposes a "quiet period"—a period when a member firm may not publish research reports on an issuer—of at least ten days following an IPO if the member firm participated as an underwriter or dealer in the IPO.[84] Since the only research analysts that initiate coverage on IPO issuers are usually affiliated with the underwriters,[85] IPO issuers have historically had to wait until after the quiet period for analyst coverage. In 2015, however, FINRA eliminated the quiet period for any issuer that qualifies as an emerging growth company ("EGC").[86] An EGC is a special category of issuer established by the JOBS Act of 2012[87] to make it easier for them to conduct IPOs.[88] An IPO issuer qualifies as an EGC if it had less than $1.07 billion of total annual gross revenues for its most recently completed fiscal year.[89] Most IPO issuers qualify as EGCs effectively eliminating the quiet period for the majority of IPOs. Despite the rule change, however, affiliated analysts generally wait 25 days before initiating coverage.[90]

That leaves management forecasts as the logical source of forecasts for IPO investors. As noted above, management forecasts are likely to be overoptimistic. One may ask whether it is worthwhile to encourage such overoptimistic forecasts. Academic research suggests the answer is yes. In her recent article, *SPAC Mergers, IPOs, and the PSLRA's Safe Harbor: Unpacking Claims of Regulatory Arbitrage*,[91] Amanda Rose surveyed academic research regarding the influence of management forecasts on the market and explained that reasonable investors take a circumspect approach to management forecasts.[92] Reasonable investors would not just take the management forecasts at face value. Rose explained:

> Studies suggest . . . for example, that the ability of a management forecast to influence the market varies depending on whether the

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[82] FINRA is registered under Exchange Act § 15A, 15 U.S.C. § 78o-3.
[83] Statistics, FINRA, https://www.finra.org/media-center/statistics (last visited Sept. 4, 2022).
[84] FINRA, Rule 2241(b)(2)(I)(i).
[85] Jia et al., *supra* note 79, at 2.
[86] FINRA, Rule 2241(b)(2)(I).
[87] The Jumpstart Our Business Startup Act (the "JOBS Act") was signed into law on April 5, 2012. Pub. L. 112-106, 126 Stat. 306 (2012).
[88] JOBS Act § 101(a) and (b), which added a new Securities Act § 2(a)(19), 15 U.S.C. § 77b(a)(19), and a new Exchange Act § 3(a)(80), 15 U.S.C. § 78c(a)(80).
[89] Securities Act § 2(a)(19), 15 U.S.C. § 77b(a)(19); Securities Act Rule 405, 17 C.F.R. § 230.405.
[90] LATHAM & WATKINS LLP, *US IPO Guide* 13 (2022 ed., June 15, 2022) https://www.lw.com/thoughtLeadership/lw-us-ipo-guide; Jia et al., *supra* note 79, at 2.
[91] Rose, *supra* note 33.
[92] *Id.*

> forecast conveys good or bad news, with the market much more skeptical of good news forecasts than bad news forecasts. Studies also suggest that the horizon and form of the management forecast matters, with annual forecasts less likely to influence the market than interim forecasts (presumably because managers are assumed to have better information about nearer-term outcomes), and range estimates less likely to influence the market than point estimates (presumably because more precise estimates suggest greater certainty on the part of management). Numerous studies also suggest that the influence a management forecast will have on the market, if any, further depends on the firm's forecasting reputation—that is, on its track record of issuing accurate guidance (or relatively more accurate guidance than analysts) in the past. The extent to which a management forecast will influence the market will also logically depend on the informativeness of the financial metric forecast, as well as on various company and industry-specific factors—such as the presence or absence of an operating history on which to base assumptions and the volatility of returns in the sector in which the firm operates. Reasonable investors can also be expected to take into account the situational incentives of the firm and managers issuing the forecast, as well as the forecast's inherent plausibility.[93]

Damodaran echoes Rose's point when he notes:

> The idea that allowing companies to make projections and fill in details about what they see in their future will lead to misleading and even fraudulent claims does not give potential buyers of its shares enough credit for being able to make their own judgments.[94]

To appreciate Rose's and Damodaran's points, one must appreciate that investors are not a homogenous group. Different investors have different levels of sophistication, including the ability to conduct valuation analyses. For illustrative purposes, this article will simplify the matter and group investors into two broad categories: sophisticated investors and ordinary investors. Sophisticated investors such as mutual funds, insurance companies, pension funds, investment banks, and other professional investors have the capacity to intelligently investigate and value securities. They have the ability to "(1) identify and obtain the information they need . . . to intelligently evaluate the worth of a given security, (2) evaluate that information, (3) recognize when they receive questionable information or

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[93] *Id.* at 28.

[94] *See* Aswath Damodaran, *Disrupting the Disruptors? The "Going Public Process" in Transition* 28 (unpublished working paper) (July 2021) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3892419).

lack sufficient information, and appropriately account for such questionable or missing information (e.g., by discounting the price they will pay for the securities investment), and (4) understand and internalize the risks involved with investing in securities."[95] Ordinary investors are basically everyone other than sophisticated investors.

Sophisticated investors can take the management forecasts, understand the information may be biased, and adjust the information accordingly before using it in their valuation models. Ordinary investors probably cannot make such adjustments, but they also are unlikely to build sophisticated valuation models in the first place and instead are mere price-takers in the market. The SEC's approach to management forecasts for IPOs appears to prioritize ordinary investors over sophisticated ones.[96] Because IPOs often involve smaller companies that are less likely to retain a large percentage of sophisticated investors until they become larger companies, there is a risk that ordinary investors will make up a significant percentage of the ultimate public share ownership for many IPOs. The SEC's position, therefore, is not unreasonable. However, if the over-optimism bias for IPO issuers can be reduced and the PSLRA Safe Harbor can be directed to apply only to honest IPO issuers, the SEC's concerns should be assuaged.

C. IPO Disclosure Rules Do Not Mandate Issuers Publish Management Forecasts

Federal securities law is grounded in a philosophy of full and fair disclosure.[97] The goal is an informationally efficient securities market where informed buyers and sellers negotiate at arm's length to determine whether transactions make sense. Basic supply and demand principles can then dictate the price and volume of these transactions. Information imperfections, however, pervade every market,[98] including stock markets.[99] For the traditional IPO market, information asymmetries are the most significant information problem.[100]

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[95] John L. Orcutt, *The Case Against Exempting Smaller Reporting Companies from Sarbanes-Oxley Section 404: Why Market-Based Solutions are Likely to Harm Ordinary Investors*, 14 FORDHAM J. CORP. & FIN. L. 325, 405 (2009).
[96] *See* Rose, *supra* note 33, at *39.
[97] *See* the Preamble to the Securities Act ("An Act 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"); Exchange Act § 2, 15 U.S.C. § 78b ("For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with the national public interest which makes it necessary to provide for regulation and control of such transactions ... including ... to require appropriate reports . . .").
[98] *See, e.g.,* Joseph E. Stiglitz, *Information and the Change in the Paradigm in Economics,* 92 AM. ECON. REV. 460, 469–70 (2002).
[99] Black, *supra* note 18, at 1567.
[100] *See id. See also,* Hayne E. Leland & David H. Pyle, *Informational Asymmetries, Financial Structure, and Financial Intermediation*, 32 J. FIN. 371, 371 (1977).

1. Information Asymmetries

Information asymmetries occur when one party to a negotiated transaction has materially better information than the other party. With IPOs, the classic information asymmetry is between the issuer's managers and prospective investors. Due to their day-to-day involvement with the company, the issuer's managers should have better information about the positives and risks involved with investing in the company than prospective investors. For example, the managers should have better information about the current and future market size for the issuer's products or services, the issuer's share of that market, and the issuer's current and future profitability.

2. IPO Disclosure Rules Focus on Historical Information

Congress explicitly designed the traditional IPO process to reduce this information imbalance between issuers and prospective investors. An issuer must register its IPO under the Securities Act, typically with a Form S-1 registration statement, before selling the stock.[101] And once the securities are issued, the issuer becomes a reporting company and must continue to provide detailed disclosure through the periodic reporting requirements of the Exchange Act.[102] The various SEC forms and regulations (most notably Regulation S-K[103] and Regulation S-X[104]) create an extensive set of issuer disclosure obligations, but not an exhaustive one. The federal mandatory disclosure system does not seek to reduce all information asymmetries; its primary focus is on historical information, not forward-looking information.

Consider the financial disclosure an IPO issuer must provide in its S-1 registration statement.[105] Table 1 sets forth the basic financial statement requirements for an IPO, all of which is historical information.

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[101] Securities Act § 5(a), 15 U.S.C. § 77e(a).
[102] Exchange Act § 13(a), 15 U.S.C. § 78m(a).
[103] 17 C.F.R. Part 229.
[104] 17 C.F.R. Part 210.
[105] Form S-1 Item 11(e), which directs the issuer to furnish the financial statements required by Regulation S-X.

Table 1
Basic Financial Statement Requirements for an IPO

	Non-Emerging Growth Companies	Emerging Growth Companies
Audited Balance Sheet	Each of the two most recent fiscal years.[106]	Same as non-emerging growth companies.[107]
Audited Statement of Comprehensive Income	Each of the three most recent fiscal years.[108]	Each of the two most recent fiscal years.[109]
Audited Statement of Cash Flows	Each of the three most recent fiscal years.[110]	Each of the two most recent fiscal years.[111]
Audited Statement of Changes in Stockholders' Equity	Each of the three most recent fiscal years.[112]	Each of the two most recent fiscal years.[113]
Interim Balance Sheet	Interim unaudited balance sheet as of the end of the most recent three-, six-, or nine-month period following the most recent audited balance sheet.[114]	Same as non-emerging growth companies.[115]
Interim Statements of Comprehensive Income, Cash Flows, and Changes in Stockholders' Equity	Interim unaudited statements of comprehensive income, cash flows, and changes in stockholders equity (a) for the stub period from the end of the latest fiscal year to the interim balance sheet date and (b) for the corresponding stub period of the prior year.[116]	Same as non-emerging growth companies.[117]

The only disclosure provisions explicitly calling for forward-looking financial information are contained in Regulation S-K Item 303(b),[118] which calls for narrative descriptions of (a) the issuer's ability to generate

[106] Regulation S-X Rule 3-01(a), 17 C.F.R. § 210.3-01(a).
[107] *Id.*
[108] Regulation S-X Rule 3-02(a), 17 C.F.R. § 210.3-02(a).
[109] *Id.*
[110] *Id*.
[111] *Id.*
[112] Regulation S-X Rule 3-04, 17 C.F.R. § 210.3-04.
[113] *Id*.
[114] Regulation S-X Rule 3-01(c), (e), (f), 17 C.F.R. § 210.3-01(c), (e), (f).
[115] *Id.*
[116] Regulation S-X Rule 3-02(b), 17 C.F.R. § 210.3-02(b) (2021); Regulation S-X Rule 3-04, 17 C.F.R. § 210.3-04.
[117] 17 C.F.R. § 210.3-02(b); 17 C.F.R. § 210.3-04.
[118] 17 C.F.R. § 229.303(b).

and obtain adequate amounts of cash to meet its short- and long-term requirements,[119] and (b) trends or uncertainties that are reasonably likely to materially affect the issuer's future liquidity,[120] capital resources,[121] or revenues or income from continuing operations.[122]

3. Voluntary Disclosure of Management Forecasts

While an issuer's future financial performance is the very heart of a stock's value, management forecasts are not mandatory disclosure items. An IPO issuer, however, may voluntarily present good faith forecasts in its registration statement as well as its Exchange Act reports.[123]

a. Prohibited Before 1973

Federal securities law did not always permit voluntary disclosure of management forecasts. For most of the period before 1973, the SEC prohibited forecasts in filed documents,[124] subject to a few limited exceptions.[125] A 1977 report by the House Committee on Interstate and Foreign Commerce explained:

> This exclusionary policy was premised on the Commission's belief that projections were not "facts," were inherently unreliable, ... and would be susceptible to improper manipulation by unscrupulous corporate managers. It was felt that an investor could make his own projections, as valid as those of management and security

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119 Regulation S-K Item 303(b)(1), 17 C.F.R. § 229.303(b)(1).
120 Regulation S-K Item 303(b)(1)(i), 17 C.F.R. § 229.303(b)(1)(i).
121 Regulation S-K Item 303(b)(1)(ii)(B), 17 C.F.R. § 229.303(b)(1)(ii)(B).
122 Regulation S-K Item 303(b)(2)(ii), 17 C.F.R. § 229.303(b)(2)(ii).
123 Regulation S-K Item 10(b)(1), 17 C.F.R. § 229.10(b)(1).
124 STAFF OF THE H. COMM. ON INTERSTATE AND FOREIGN COM., 95TH CONG., 1ST SESS., REPORT APPENDIX TO THE REP. OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION A-267 – A-270 (Comm. Print 1977) [hereinafter REPORT OF THE ADVISORY COMMITTEE]. *See also* Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, Exchange Act Release No. 9984 *1 (Feb. 2, 1973) [hereinafter Release No. 33-5362] ("It has been the Commission's long standing policy generally not to permit projections to be included in prospectuses and reports filed with the Commission.").
125 The SEC recognized a few exceptions to its exclusionary policy. The REPORT OF THE ADVISORY COMMITTEE, *supra* note 124, noted:

> [R]eal estate companies were often permitted to include earnings projections in their registration statements, presumably on the theory that such companies had a fairly constant and predictable income level. In addition, projection data was often permitted, if not required, in Commission filings when the information was of a negative character, even though favorable disclosures on the same subjects were normally prohibited. Further, as a matter of practice, the Commission demonstrated considerable tolerance towards projections in filings concerned with mergers, acquisitions, tender offers and proxy contests; those situations in which an investor was perceived as needing "fair" and "balanced," as opposed to "conservative," disclosures. *Id.* at A-270.

> analysts, based on the historical information made publicly-available by reporting companies.[126]

In February 1973, after a series of public hearings and input, the SEC changed its position.[127] The SEC determined "that changes in its present policies with regard to use of projections would assist in the protection of investors and would be in the public interest."[128] When announcing this new policy, the SEC noted its recognition "that projections are currently widespread in the securities markets and are relied upon in the investment process. Persons invest with the future in mind and the market value of a security reflects the judgments of investors about the future economic performance of the issuer."[129] In conjunction with its new policy, the SEC issued its first set of guidelines for formulating and disclosing management forecasts in SEC filings.[130]

b. Current SEC Guidelines—Regulation S-K Item 10(b)

The SEC's current guidelines for formulating and disclosing forecasts in SEC filings are set forth in Regulation S-K Item 10(b).[131] Item 10(b) explains that the SEC "encourages" the inclusion of forecasts in SEC filings "that have a reasonable basis and are presented in an appropriate format."[132] Item 10(b) goes on to articulate the SEC's "views on important factors to be considered in formulating and disclosing such [forecasts]."[133]

i. Reasonable Basis for Forecasts—Item 10(b)(1)

Item 10(b)(1) expressly states the SEC's belief that "management must have the option to present in Commission filings its good faith assessment of a registrant's future performance."[134] However, management "must have a reasonable basis for such an assessment."[135] Item 10(b)(1) provides little guidance for determining what qualifies as a reasonable basis. Historical experience may be helpful in establishing a reasonable basis but is not required. The SEC "does not believe that a registrant always must have had such a history or experience in order to formulate projections with a reasonable basis."[136] An outside review of the forecasts "may furnish additional support for having a reasonable basis for a projection."[137] If an outside review is included with the filing, "there also should be disclosure of the qualifications of the reviewer, the extent of the review, the

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[126] *Id*. at A-268.
[127] Release No. 33-5362, *supra* note 124, at *1.
[128] *Id.*
[129] *Id.*
[130] *Id*. at *3–4.
[131] 17 C.F.R. § 229.10(b).
[132] *Id*.
[133] *Id*.
[134] 17 C.F.R. § 229.10(b)(1).
[135] *Id.*
[136] *Id*.
[137] *Id.*

relationship between the reviewer and the [issuer], and other material factors concerning the process by which any outside review was sought or obtained."[138]

ii. Format for Forecasts—Item 10(b)(2)

The issuer must present the forecasts in an "appropriate format" so as not to mislead investors.[139] The issuer may not use presentational tricks to deceive investors about the forecasts. Item 10(b)(2) states that "consideration must be given to . . . the financial items to be projected, the period to be covered, and the manner of presentation to be used."[140]

- **Financial items to be projected.** When publishing forecasts, issuers are generally expected to include forecasts for revenues, net income (loss), and earnings-(loss)-per-share, although forecasts "need not necessarily be limited to those three items."[141] One presentational trick an issuer may want to use is selectively disclosing only favorable items. Item 10(b)(2) prohibits such strategic behavior. Issuers have some leeway in choosing what forecasts to disclose, but such choices must not be susceptible to misleading inferences.[142]
- **Period to be covered.** Management should present a reporting period for the forecasts that is "most appropriate in the circumstances."[143] A two- or three-year projection period may be reasonable for some issuers, while other issuers may not have a reasonable basis for projections beyond the current year.[144]
- **Manner of presentation.** Management should disclose what, in its opinion, is the most probable, or most reasonable, range for each financial item projected based

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138 *Id.*
139 Regulation S-K Item 10(b)(2), 17 C.F.R. § 229.10(b)(2).
140 *Id*.
141 *Id*.
142 *Id*. Item 10(b)(2) states:

> [M]anagement should take care to assure that the choice of items projected is not susceptible of misleading inferences through selective projection of only favorable items. Revenues, net income (loss) and earnings (loss) per share usually are presented together in order to avoid any misleading inferences that may arise when the individual items reflect contradictory trends. There may be instances, however, when it is appropriate to present earnings (loss) from continuing operations in addition to or in lieu of net income (loss). It generally would be misleading to present sales or revenue projections without one of the foregoing measures of income. *Id.*

143 *Id*.
144 *Id*.

> on the selected assumptions.[145] Item 10(b)(2) cautions, however, that ranges "should not be so wide as to make the disclosures meaningless."[146]

iii. Investor Understanding—Item 10(b)(3)

Item 10(b)(3)[147] provides guidance on the issuer's disclosure that accompanies the forecasts. Such disclosures "should facilitate investor understanding of the basis for and limitations of projections."[148] Item 10(b)(3)(i) goes on to explain:

> In this regard investors should be cautioned against attributing undue certainty to management's assessment, and the Commission believes that investors would be aided by a statement indicating management's intention regarding the furnishing of updated projections. The Commission also believes that investor understanding would be enhanced by disclosure of the assumptions which in management's opinion are most significant to the projections or are the key factors upon which the financial results of the enterprise depend and encourages disclosure of assumptions in a manner that will provide a framework for analysis of the projection.[149]

II. ISSUER LIABILITY FOR INACCURATE FORECASTS

Federal securities law seeks to reduce information asymmetries between issuers and investors through an in-depth disclosure system that dictates what information issuers must, may, and may not disclose.[150] Economists warn, however, that such self-reported disclosure may not be reliable because "words are cheap."[151] Issuers cannot be expected to be entirely straightforward with their disclosure, "since there may be substantial rewards for exaggerating positive qualities. And verification of true characteristics by outside parties may be costly or impossible."[152] To discourage dishonest disclosure, Congress established an extensive anti-fraud liability system that imposes costs on misrepresentations. There is criminal, administrative, and civil liability for violating federal disclosure

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[145] *Id*.
[146] *Id*.
[147] 17 C.F.R. § 229.10(b)(3).
[148] 17 C.F.R. § 229.10(b)(3)(i).
[149] *Id*.
[150] *See* Anand Das, *A License to Lie: The Private Securities Litigation Reform Act's Safe Harbor for Forward-Looking Statements Does Not Protect False or Misleading Statements When Made with Meaningful Cautionary Language*, 60 CATH. U. L. REV. 1083, 1083 (2011).
[151] Michael Spence, *Informational Aspects of Market Structure: An Introduction*, 90 Q. J. ECON. 591, 593 (1976).
[152] Leland & Pyle, *supra* note 100, at 371.

laws.[153] In the case of an IPO, issuers and various other actors can be held liable for material misstatements or omissions in the registration statement or other communications associated with the IPO.

A. Primary Liability Provisions

Stockholder class actions pose the biggest liability threat for most IPO issuers. Such stockholder suits usually involve one or more of the following provisions: (1) Securities Act section 11;[154] (2) Securities Act section 12(a)(2);[155] and (3) Exchange Act Rule 10b-5.[156]

- **Section 11** is the Securities Act's registration statement liability provision. It grants securities purchasers an express cause of action against the issuer and enumerated individuals if "any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[157]
- **Section 12(a)(2)** is the prospectus liability provision. It grants securities purchasers a private cause of action that is like section 11, but that applies to untrue statements of a material fact or material omissions in the prospectus or in oral communications.[158]
- **Rule 10b-5** is the general anti-fraud provision of the federal securities law system. Promulgated by the SEC pursuant to its Exchange Act section 10(b)[159] rulemaking authority, Rule 10b-5 outlaws untrue statements of a material fact, material omissions, or fraud, in connection with the purchase or sale of securities. Rule 10b-5 has a higher burden of proof than sections 11 and 12(a)(2) because plaintiffs must show the defendant acted with *scienter* (a "mental state embracing intent to deceive, manipulate, or defraud"[160]). Section 11 and section 12(a)(2) liability only apply to securities offerings, while Rule 10b-5 liability has broader reach. Rule 10b-5 liability can stem from securities-offering disclosures as well as disclosures made in

[153] *See, e.g.*, Securities Act § 11, 15 U.S.C. § 77k; Securities Act § 12(a)(2), 15 U.S.C. § 77l(a)(2); Securities Act § 15, 15 U.S.C. § 77o; Securities Act § 17(a), 15 U.S.C. § 77q(a); Exchange Act § 10(b), 15 U.S.C. § 78j(b); Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5; Exchange Act § 14(a), 15 U.S.C. § 78n(a); Exchange Act Rule 14a-9, 17 C.F.R. § 240.14a-9; Exchange Act § 15(c)(1), 15 U.S.C. § 78o(c)(1); Exchange Act § 20, 15 U.S.C. § 78t.
[154] 15 U.S.C. § 77k.
[155] 15 U.S.C. § 77l(a)(2).
[156] 17 C.F.R. § 240.10b-5.
[157] Securities Act § 11(a), 15 U.S.C. § 77k(a).
[158] Securities Act § 12(a)(2), 15 U.S.C. § 77l(a)(2).
[159] 15 U.S.C. § 78j(b).
[160] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976).

connection with an issuer's Exchange Act reporting obligations and its day-to-day communications.

B. Can Forecasts be Misleading Statements of Fact?

Section 11, section 12(a)(2), and Rule 10(b)(5) each create liability for material misrepresentations of fact or material omissions. How do forecasts fit within that framework? A forecast is a subjective statement of opinion. A forecast states that an outcome may occur; it does not guarantee that it will occur. How is that a material misstatement of fact or a material omission?

1. *Omnicare* Decision

In *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*,[161] the Supreme Court considered liability for opinions under section 11. *Omnicare* held that opinions are actionable (assuming materiality) in three situations:

- **Situation 1—material misrepresentation of fact.** An opinion is an untrue statement of fact if the speaker did not actually hold the stated opinion.[162] Liability may follow if the speaker did not subjectively hold the stated belief and the belief turns out to be objectively false.[163] For example, assume an issuer's CEO forecasts current-year earnings-per-share of $2.00 to $2.25, but actually believes the earnings-per-share will fall within a range $1.50 to $1.75. If the issuer's earnings-per-share turn out to be less than $2.00, the CEO's forecast would be actionable as a misrepresentation of fact (assuming the misrepresentation was material).
- **Situation 2—embedded facts are materially false or misleading.** An opinion may include embedded statements of fact that can be proven false.[164] For example, assume an issuer publishes an earnings forecast that assumes strong profit margins due in part to the issuer's strong patent portfolio. The opinion includes an embedded statement of fact that the issuer has a strong patent portfolio. If the issuer has no such patent portfolio, the supporting statement of fact would be a misrepresentation and actionable if the misrepresentation was material.

[161] Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 575 U.S. 175 (2015).
[162] *Id*. at 184–85. *See also* Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1092 (1991).
[163] *Omnicare, Inc.*, 575 U.S. at 184–85.
[164] *Id*. at 185–86.

- **Situation 3—material omission.** "[A] reasonable investor may, based on the circumstances, understand an opinion conveys facts about how the speaker formed the opinion."[165] An opinion can be actionable if the speaker omits a material fact going to the basis of the opinion whose omission makes the opinion misleading to a reasonable person reading the statement fairly and in context.[166] In *Omnicare*, the Supreme Court adopted an objective, reasonable investor approach to evaluating undisclosed facts relating to opinions. A reasonable investor understands that opinion statements communicate less certainty than statements of fact (saying "I think we are in compliance with the law" is less certain than saying "we comply with the law"). However, a reasonable investor may, depending on the circumstances, "understand an opinion statement to convey facts about how the speaker has formed the opinion—or, otherwise put, about the speaker's basis for holding that view. And if the real facts are otherwise, but not provided, the opinion statement will mislead its audience."[167]

Omnicare's omission theory offers plaintiffs a potentially attractive "avenue of attack."[168] A reasonable investor expects not only that the issuer believes the opinion. A reasonable investor may also expect the opinion "fairly aligns with the information in the issuer's possession at the time.

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[165] *Id.* at 188.
[166] *Id*. at 188–89.
[167] *Id.* at 188. The Supreme Court offered the following example:

> Consider an unadorned statement of opinion about legal compliance: "We believe our conduct is lawful." If the issuer makes that statement without having consulted a lawyer, it could be misleadingly incomplete. In the context of the securities market, an investor, though recognizing that legal opinions can prove wrong in the end, still likely expects such an assertion to rest on some meaningful legal inquiry—rather than, say, on mere intuition, however sincere. Similarly, if the issuer made the statement in the face of its lawyers' contrary advice, or with knowledge that the Federal Government was taking the opposite view, the investor again has cause to complain: He expects not just that the issuer believes the opinion (however irrationally), but that it fairly aligns with the information in the issuer's possession at the time. Thus, if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then § 11's omissions clause creates liability. *Id.* at 188–89.

[168] Chris Provenzano, *2nd Circ. Gives Teeth To Omnicare Securities Fraud Standard*, LAW360 (Oct. 21, 2020), https://www.law360.com/articles/1320195/2nd-circ-gives-teeth-to-omnicare-securities-fraud-standard. *See also* Joshua G. Hamilton, James H. Moon & Oliver Rocos, *Ninth Circuit Applies "Omnicare" to Section 10(b) and Rule 10b-5 Claims*, LATHAM & WATKINS CLIENT ALERT COMMENTARY 3 (May 15, 2017), https://www.jdsupra.com/legalnews/ninth-circuit-applies-omnicare-to-48130/.

Thus, if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then § 11's omissions clause creates liability."[169]

The Supreme Court cautioned, however, against stretching the omission theory too far and explained that establishing the omission theory is "no small task."[170]

> An opinion statement . . . is not necessarily misleading when an issuer knows, but fails to disclose, some fact cutting the other way. Reasonable investors understand that opinions sometimes rest on a weighing of competing facts . . . . A reasonable investor does not expect that *every* fact known to an issuer supports its opinion statement.[171]

As explained below, this type of subjective inquiry is ripe for hindsight bias. Latham & Watkins sent out a 2017 client alert explaining:

> [T]here remains substantial uncertainty in how district courts will evaluate [omission theory] cases in practice to determine whether the [purported] omission is misleading to a "reasonable person reading the statement fairly and in context." As noted in the concurring opinions by Justice Antonin Scalia and Clarence Thomas in *Omnicare*, the omission theory of liability articulated by the Supreme Court is "highly fact-intensive" and creates substantial uncertainty for issuers that must now determine whether their opinions might be misconstrued by "reasonable" persons.[172]

2. Several Circuits have Extended *Omnicare* to Section 10(b) and Rule 10b-5

Omnicare dealt with opinions in the context of a section 11 claim. Since the *Omnicare* opinion was issued, the First,[173] Second,[174] Ninth,[175] Tenth,[176] and Eleventh[177] Circuits have applied *Omnicare*'s standard for determining whether a statement of opinion is actionable to statements of

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[169] *Omnicare, Inc.*, 575 U.S. at 189.
[170] *Id*. at 194.
[171] *Id*. at 189–90.
[172] Hamilton et al., *supra* note 168, at 3.
[173] Constr. Indus. and Laborers v. Carbonite, 22 F.4th 1, 7 (1st Cir. 2021).
[174] Tongue v. Sanofi, 816 F.3d 199, 209–10 (2d Cir. 2016).
[175] City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech., Inc., 856 F.3d 605, 615–16 (9th Cir. 2017).
[176] Nakkhumpun v. Taylor, 782 F.3d 1142, 1159 (10th Cir. 2015).
[177] Carvelli v. Ocwen Fin. Corp., 934 F.3d 1307, 1322 (11th Cir. 2019).

opinion under section 10(b) and Rule 10b-5. For example, the Eleventh Circuit explained in *Carvelli v. Ocwen Fin. Corp.*[178]:

> Although neither the Supreme Court nor this Court has addressed the status of statements of opinion under § 10(b) and Rule 10b-5, in *Omnicare* the Supreme Court adopted a standard for determining whether a statement of opinion is actionable under § 11 of the Securities Act of 1933. . . . Because the core prohibition of Rule 10b-5(b) is worded in the exact same language as § 11 . . . we conclude that *Omnicare's* analysis controls here.[179]

It would not be surprising if all the circuits eventually extend *Omnicare's* opinion treatment to section 10(b) and Rule 10b-5,[180] as well as to section 12(a)(2).[181] When evaluating an IPO issuer's liability risk for publishing inaccurate management forecasts, this article assumes that *Omnicare's* analysis would apply to any section 11, section 12(a)(2), or Rule 10b-5 claims.

C. Hindsight Bias and Litigation Risk

An anti-fraud liability system works best when one can easily differentiate dishonest disclosure from honest disclosure. Thus, it works well for disclosures about an issuer's past performance, since such information generally involves verifiable facts that are either true, or not true. Differentiating honest issuers and their good-faith management forecasts from dishonest issuers and their exaggerated forecasts is not so easy. Forecasts are not concrete facts. They are subjective predictions of an uncertain future. They require choosing a limited number of possible outcomes from a distribution of possibilities. The greater the uncertainty, the wider the distribution of possibilities. Because IPO issuers tend to be growth companies with highly uncertain future performances, their distribution of possibilities can be very wide. As a result, producing perfectly accurate forecasts is next to impossible, "as there are many unpredictable events that can take place between the forecast day and the day of the official announcement of actual earnings."[182]

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[178] *Id*.

[179] *Id.* at 1322 n.7.

[180] *But see In re* Amarin Corp. PLC Sec. Litig., 2022 WL 2128560, *3 n.7 (3d Cir. 2022) ("We have not yet decided whether the framework in *Omnicare* is applicable to claims under § 10(b) of the Exchange Act.").

[181] On a related note, the Fourth Circuit (*Paradise Wire & Cable Defined Benefit Pension Plan v. Weil*, 918 F.3d 312 (4th Cir. 2019)) and the Ninth Circuit (*Golub v. Gigamon Inc.*, 994 F.3d 1102 (9th Cir. 2021)) have held that *Omnicare's* standard for determining whether a statement of opinion is actionable also applies to Exchange Act § 14(a), 15 U.S.C. § 78n(a), and Exchange Act Rule 14a-9, 17 C.F.R. § 240.14a-9.

[182] Sabri Boubaker et al., *Management Earnings Forecasts and IPO Performance: Evidence of a Regime Change*, 48 REV. QUANT. FIN. ACC. 1083, 1084 (2017).

The federal anti-fraud liability system is not meant to punish honest issuers for producing good faith forecasts that turn out to be wrong. However, determining whether an inaccurate management forecast was originally formulated and disclosed in good faith often requires subjective determinations; particularly when applying *Omnicare's* omission theory. Management forecasts almost always involve competing scenarios and competing facts that require the issuer to make numerous subjective judgments (a) to interpret facts that are embedded within the forecasts and decide how they affect the forecasts and (b) to determine what to disclose, and what to omit. Making those subjective determinations is no easy task for a court, and it is made even harder by a well-documented bias that psychologists refer to as hindsight bias. Hindsight bias is a human tendency to perceive an uncertain event as having been more easily predictable after the outcome is known that it was before the outcome was known.[183] We struggle "to recapture the feeling of uncertainty that preceded an event."[184] In their paper on hindsight bias in legal judgments, Kim Kamin and Jeffrey Rachlinski explain:

> Ignoring a known outcome while recreating a decision is a difficult cognitive task. In making such judgments, people overestimate both the probability of the known outcome and the ability of decision makers to foresee the outcome . . . . When trying to reconstruct what a foresightful state of mind would have perceived, people remain anchored in the hindsightful perspective. This leaves the reported outcome looking much more likely than it would look to the reasonable person without the benefit of hindsight. [185]

Hindsight bias has been widely studied[186] and documented in "diverse domains, including labor disputes . . . ., terrorist attacks . . . ., medical diagnoses . . . ., consumer satisfaction . . . ., managerial choice . . . ., accounting and auditing decisions . . . ., business startups . . . ., public policy . . ., and political strategy."[187] It has also been well documented in

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[183] Neal J. Roese & Kathleen D. Vohs, *Hindsight Bias*, 7 PERSPS. ON PSYCHOL. SCI. 411, 411 (2012).
[184] *Id.*
[185] Kim A. Kamin & Jeffrey J. Rachlinski, *Ex Post ≠ Ex Ante: Determining Liability in Hindsight*, 19 LAW HUM. BEHAV. 89, 90 (1995).
[186] Baruch Fischoff published a seminal empirical study showing hindsight bias in 1975. Baruch Fischoff, *Hindsight ≠ Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 J. EXPERIMENTAL PSYCHOL.: HUM. PERCEPTION & PERFORMANCE 288, 288 (1975). In a 2012, review of hindsight bias research, Neal Roese and Kathleen Vohs explained, "Hindsight bias is one of the most widely studied of decision traps, having been featured in more than 800 scholarly papers." Roese & Vohs, *supra* note 183, at 411.
[187] Roese & Vohs, *supra* note 183, at 411–12.

legal settings, where it has been shown to affect judgments of legal culpability by judges and juries.[188]

In the case of stockholder class actions for inaccurate management forecasts, judges and juries may allow their knowledge of the inaccurate forecasts to cloud the various determinations they must make, many of which are highly subjective. Did management subjectively believe the inaccurate forecasts? What additional facts were embedded into the management forecasts, and how should such facts be interpreted? Did the issuer omit factual information from its forecasts that would cause a reasonable investor to view the forecasts as misleading?

Hindsight bias could be particularly troubling for the determinations required by the omissions theory. Management forecasts require the issuer's managers to sift through and interpret reams of data and facts to crystallize a range of outcomes. By definition, numerous facts will not be communicated to investors when the forecasts are disclosed. Determining whether those omitted facts are actionable is just the type of analysis that can easily fall prey to the hindsight bias.

While hindsight bias *could* be a concern, it is not clear whether it truly is. Hindsight bias is a well-documented phenomenon in many areas, but it has not been empirically shown to be a problem in the case of stockholder lawsuits for inaccurate management forecasts. It is worth considering whether hindsight bias is more bogeyman than actual threat for increasing an issuer's risk of being found liable for a false or misleading statement of fact. However, even if disclosing management forecasts that ultimately prove to be inaccurate does not substantially increase the *liability risk* for issuers and the other typical IPO defendants, it almost certainly increases their *risk of being sued*.[189] IPO issuers who miss their forecast estimates by a substantial amount make for attractive lawsuit targets.

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[188] Nicolas Bourtin, *Combatting Hindsight Bias in White-Collar Criminal Investigations*, N.Y. L. J. (Apr. 3, 2017), http://www.law.nyu.edu/sites/default/files/Bourtin_New_York_Law_Journal_Hindsight_Bias_WhiteCollar_Investigations_2017_FIN.pdf.

[189] *See* David R. Herwitz, *The Risk of Liability for Forecasting*, 2 OBJECTIVES OF FINANCIAL STATEMENTS: SELECTED PAPERS 247 (1974). Concern about an increased litigation risk, even if the liability risk does not necessarily increase, has been around for quite some time. Herwitz made the point back in 1974.

> On principle it would appear that management would not be liable for a forecast merely because it turned out to be wide of the mark, if it were made in good faith and for a proper purpose, if it represented management's actual belief as to the future prospects, and were prepared with reasonable care and skill . . . . However, this optimistic prognosis must be tempered with the caveat that, if management forecasts became a regular feature of the reporting scene, at least in the short run there might well be a significant increase in the *risk of being sued*, as distinguished from the risk of liability, because forecasts that go

High defense costs and uncertainties can make settling certain types of cases the most economically sound strategy for defendants even when they have a high chance of success on the merits. In the management forecast context, the inquiries required to determine liability require factual determinations that can preclude early case dismissals, which increases defense costs and uncertainties, and creates a favorable environment for strike suits. It is not surprising, therefore, when IPO issuers simply choose not to disclose management forecasts in their registration statements. The issuers' (and the other IPO defendants') concern is less about liability risk and more about litigation risk.

D. Cautionary Statements and the Bespeaks Caution Doctrine

One strategy IPO issuers can use to reduce liability risk (and possibly litigation risk) for management forecasts is to include meaningful cautionary statements that are specific, factual, and relate closely to the forecasts. Such a strategy can invoke the bespeaks caution doctrine, which holds that sufficient cautionary language may insulate forward-looking statements from being actionable.[190] The Eighth Circuit was the first circuit to adopt the bespeaks caution doctrine with its *Polin v. Conductron Corp.*[191] decision in 1977. Since then, every circuit court of appeals has endorsed the doctrine in some form[192] except the D.C. Circuit Court of Appeals (although several district courts in the D.C. Circuit have applied the doctrine).[193]

Courts have applied the bespeaks caution doctrine in a few ways.[194] Under one line of cases, courts use the doctrine to address the materiality element of securities fraud claims.[195] Misstatements or omissions must be

awry will present a very inviting target to potential stockholder litigants.
Id. at 247.

[190] THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 494 (Hornbook Series, 8th ed., 2021).

[191] Polin v. Conductron Corp., 552 F.2d 797, 806 n.28 (8th Cir. 1977) ("The terms thus employed bespeak caution in outlook and fall far short of the assurances required for a finding of falsity and fraud."), *cert. denied*, 434 U.S. 857 (1977).

[192] *See e.g.*, Romani v. Shearson Lehman Hutton, 929 F.2d 875 (1st Cir. 1991); I. Meyer Pincus & Assocs. v. Oppenheimer & Co., 936 F.2d 759 (2d Cir. 1991); *In re* Donald J. Trump Casino Sec. Litig., 7 F.3d 357 (3d Cir. 1993); Gasner v. Board of Sup'rs of the Cnty. Of Dinwiddie, 103 F.3d 351 (4th Cir. 1996); Rubinstein v. Collins, 20 F.3d 160 (5th Cir. 1994); Sinay v. Lamson & Sessions Co., 948 F.2d 1037 (6th Cir. 1991); Harden v. Raffensperger, Hughes & Co., 65 F.3d 1392 (7th Cir. 1995); *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407 (9th Cir. 1994); Grossman v. Novell, Inc., 120 F.3d 1112 (10th Cir. 1997); Saltzberg v. TM Sterling/Austin Assocs., 45 F.3d 399 (11th Cir. 1995).

[193] *See, e.g.*, *In re* XM Satellite Radio Holdings Sec. Litig., 479 F.Supp.2d 165 (D.D.C. 2007); *In re* Baan Co. Sec. Litig., 103 F.Supp.2d 1 (D.D.C. 2000).

[194] Todd J. Frye, *Application of the Safe Harbor for Forward-Looking Statements*, FINDLAW ATT'Y WRITERS (Mar. 26, 2008), https://corporate.findlaw.com/finance/application-of-the-safe-harbor-for-forward-looking-statements.html.

[195] *Id.*

material[196] to generate securities fraud liability. For example, in *Harden v. Raffensperger, Hughes & Co., Inc.*, the Seventh Circuit explained:

> [W]hen forecasts, opinions, or projections in a disclosure statement are accompanied by meaningful warnings and cautionary language, the forward-looking statements may not be misleading. The substantial disclosure of specific risks may render alleged misrepresentations or omissions concerning soft information immaterial and thus nonactionable as securities fraud.[197]

Determining materiality requires analyzing statements in context. The bespeaks caution doctrine recognizes that concept.[198] However, not every cautionary statement is sufficient to immunize a forward-looking statement. "[T]he cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions ... which the plaintiffs challenge."[199] The bespeaks caution doctrine has the potential to reduce an IPO issuer's litigation risk because, in appropriate cases, it "may properly be applied in considering a motion to dismiss."[200]

The PSLRA Safe Harbor did not replace the bespeaks caution doctrine[201] but instead simply provides more clearly defined protections for defendants. As a result, the bespeaks caution doctrine should continue to apply to IPOs and management forecasts. Having said that, IPO issuers have not been keen on relying on the doctrine for management forecasts as evidenced by their unwillingness to disclose such forecasts in their

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[196] The Supreme Court has defined "materiality" to encompass those facts that a reasonable investor would consider important when making an investment decision (such as whether to buy or sell securities or how to vote in a corporate election). A fact is material if there is a substantial likelihood that a reasonable investor would attach significance to it when making an investment decision because the fact significantly alters the total mix of available information. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976) and Basic Inc. v. Levinson, 485 U.S. 224 (1988). *TSC Industries*, which is arguably the leading case on materiality, defined materiality for Section 14 of the Exchange Act (tender offer disclosure). In *Basic*, the Supreme Court expressly adopted the *TSC Industries* definition of materiality for the Section 10(b) and Rule 10b-5 context. *Basic Inc.*, 485 U.S. at 249. The Supreme Court's materiality definition in *TSC Industries* and *Basic* has also been captured in Securities Act Rule 405, 17 C.F.R. § 230.405, and Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2.

[197] *Harden*, 65 F.3d at 1404 (quoting from 3B Harold S. Bloomenthal, *Securities and Federal Corporate Law* § 8.26 [1] at 8–110 (1995)).

[198] Rubinstein v. Collins, 20 F.3d 160, 167 (5th Cir. 1994) ("[T]he "bespeaks caution" doctrine merely reflects the unremarkable proposition that statements must be analyzed in context.").

[199] *In re* Donald J. Trump Casino Sec. Litig., 7 F.3d 357, 371–72 (3d Cir. 1993).

[200] Grossman v. Novell, Inc., 120 F.3d 1112, 1120 n.7 (10th Cir. 1997) (citing to *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d at 371); Romani v. Shearson Lehman Hutton, 929 F.2d 875, 879 (1st Cir. 1991); *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1413 (9th Cir. 1994); San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Companies, Inc., 75 F.3d 801, 811 (2d Cir. 1996)).

[201] PSLRA Conf. Rep., *supra* note 16, at 46.

registration statements. There could be a few reasons for this outcome. First, the SEC retains a lot of control over registration statement disclosure through its registration statement review and acceleration of effectiveness processes. Spencer Feldman explains, "The more an [IPO] issuer distances itself from the projections by disclosing significant business, economic, regulatory and competitive uncertainties or by seeking to disclaim the accuracy of the projections, the more the SEC will question the appropriateness for inclusion of such information in the first place."[202] Second, the Safe Harbor explicitly excludes from its protections forward-looking statements made in connection with IPOs, and the SEC has explicitly chosen not to extend the Safe Harbor to IPOs. Congress and the SEC have made clear their concerns about encouraging IPO issuers to disclose management forecasts. Courts are certain to hear that message, and it could motivate them to apply the bespeaks caution doctrine more narrowly and to grant motions to dismiss more sparingly. Whatever the reason, the bespeaks caution doctrine does not appear to provide IPO issuers with sufficient comfort to publish management forecasts.

E. The Regulatory and Statutory Safe Harbors

To encourage issuers to disclose management forecasts and other forward-looking information, the SEC and Congress eventually decided to address issuers' liability and litigation concerns by creating safe harbors. The SEC adopted the first forward-looking statement safe harbor in 1979 with Securities Act Rule 175[203] and Exchange Act Rule 3b-6,[204] and Congress followed with the PSLRA Safe Harbor in 1995.

1. Rules 175 and 3b-6

When the SEC changed its policy on management forecasts from exclusionary to inclusionary in 1973, it recognized that liability concerns could deter issuers from providing such disclosure.[205] Hoping to remedy this problem, the SEC adopted Rule 175 for the Securities Act and its identical provision, Rule 3b-6, for the Exchange Act to create safe harbors for certain forward-looking statements.[206] The rules define a "forward-looking statement" as:

- Projections of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure, or other financial items.

[202] Feldman, *supra* note 1.
[203] 17 C.F.R. § 230.175.
[204] 17 C.F.R. § 240.3b-6.
[205] Release No. 33-5362, *supra* note 124, at *3 ("The Commission is aware of the fact that one of the primary deterrents to a rational and open disclosure system for projections is the fear of liability for inaccurate projections").
[206] Final Rules, Safe Harbor Rule for Projections, Securities Act Release No. 6084, Exchange Act Release No. 15944 (June 25, 1979).

- Statements of management's plans and objectives for future operations.
- Statements of future economic performance contained in the issuer's management discussion and analysis disclosure.
- Disclosed assumptions underlying or relating to the forward-looking statements.[207]

Forward-looking statements made by or on behalf of an issuer (or by an outside reviewer retained by the issuer) in an SEC filing are not "fraudulent statements"[208] (e.g., they are not material misrepresentations of fact or material omissions) unless the plaintiff can show the statement "was made or reaffirmed without a reasonable basis or was disclosed other than in good faith."[209] Rules 175 and 3b-6 only protect statements made in SEC filings.[210]

Rules 175 and 3b-6 did not have their desired effect. As of 1994, issuers generally were not invoking the Rule 175/Rule 3b-6 safe harbor in litigation.[211] The SEC explained at the time:

> The safe harbor is infrequently raised by defendants, perhaps because it compels judicial examination of reasonableness and good faith, which raise factual issues that often preclude early, prediscovery dismissal. Thus, critics state that the safe harbor is ineffective in ensuring the quick and inexpensive dismissal of frivolous private lawsuits.[212]

While the rules may provide some help for issuers' ultimate liability risk, they do little to remove their litigation risk.[213] To gauge whether issuers and other defendants continue not to invoke the Rule 175/Rule 3b-6 safe harbor after 1994, this author conducted the following search in the Westlaw federal case database on July 30, 2022: "exchange act" /50 "rule 3b-6" or

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[207] Securities Act Rule 175(c), 17 C.F.R. § 230.175(c); Exchange Act Rule 3b-6(c), 17 C.F.R. § 240.3b-6(c).
[208] Securities Act Rule 175(d), 17 C.F.R. § 230.175(d); Exchange Act Rule 3b-6(d), 17 C.F.R. § 240.3b-6(d).
[209] Securities Act Rule 175(a), 17 C.F.R. § 230.175(a); Exchange Act Rule 3b-6(a), 17 C.F.R. § 240.3b-6(a).
[210] Securities Act Rule 175(b), 17 C.F.R. § 230.175(b); Exchange Act Rule 3b-6(b), 17 C.F.R. § 240.3b-6(b).
[211] Concept Release and Notice of Hearing, Safe Harbor for Forward-Looking Statements, Securities Act Release No. 7101, Exchange Act Release No. 34831, Investment Company Act Release No. 20613 *8 (Oct. 13, 1994) [hereinafter Release No. 33-7101].
[212] *Id.* at *9.
[213] *See* Allan Horwich, *Cleaning the Murky Safe Harbor for Forward-Looking Statements: An Inquiry into Whether Actual Knowledge of Falsity Precludes the Meaningful Cautionary Statement Defense*, 35 J. CORP. L. 519, 522 (2010).

"securities act" /50 "rule 175" and date restricted after December 31, 1994. The search only returned three cases.[214]

The SEC considered revising Rules 175 and 3b-6 in 1994 to address concerns with the rules,[215] but Congress affectively ended the effort when it adopted the PSLRA Safe Harbor in 1995.

2. The PSLRA Safe Harbor

The PSLRA Safe Harbor is contained in Securities Act section 27A and Exchange Act section 21E. Like Rules 175 and 3b-6, sections 27A and 21E are identical in all material respects. The difference between the two provisions is that section 27A applies to private actions arising under the Securities Act,[216] while section 21E applies to private actions arising under the Exchange Act.[217] This article refers to sections 27A and 21E collectively as the PSLRA Safe Harbor.

Subject to certain exclusions,[218] the PSLRA Safe Harbor applies to forward-looking statements made by issuers that are reporting companies, persons acting on behalf of such issuers, outside reviewers retained by such issuers, and underwriters who obtained or derived the forward-looking information from such issuers.[219] The PSLRA Safe Harbor's "forward-looking statement" definition is substantially like the ones in Rules 175 and 3b-6 and includes:

- Projections of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure, or other financial items.
- Statements of management's plans and objectives for future operations, including plans or objectives relating to the issuer's products or services.
- Statements of future economic performance contained in the issuer's management discussion and analysis disclosure or in the results of operations included pursuant to SEC rules and regulations.
- Disclosed assumptions underlying or relating to the forward-looking statements.[220]

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[214] *In r*e Mesa Airlines Sec. Litig., 1996 WL 33419894 (D.N.M. May 31, 1996); S.E.C. v. Platforms Wireless Intern. Corp., 2008 WL 281112 (S.D. Cal. 2008) (also cited in a 2007 decision for this case); U.S. v. Nacchio, 519 F.3d 1140 (10th Cir. 2008).
[215] The SEC issued a concept release and scheduled public hearings to discuss the topic. Release No. 33-7101, *supra* note 211, at *1.
[216] Securities Act § 27A(c)(1), 15 U.S.C. § 77z-2(c)(1).
[217] Exchange Act § 21E(c)(1), 15 U.S.C. § 78u-5(c)(1).
[218] Securities Act § 27A(b), 15 U.S.C. § 77z-2(b)); Exchange Act § 21E(b), 15 U.S.C. § 78u-5(b).
[219] Securities Act § 27A(a), 15 U.S.C. § 77z-2(a)); Exchange Act § 21E(a), 15 U.S.C. § 78u-5(a).
[220] Securities Act § 27A(i)(1), 15 U.S.C. § 77z-2(i)(1); Exchange Act § 21E(i)(1), 15 U.S.C. § 78u-5(i)(1).

a. Two Safe Harbors

The PSLRA Safe Harbor contains two forward-looking-statement safe harbors.

i. First Safe Harbor—Meaningful Cautionary Statements

The first safe harbor immunizes forward-looking statements from private litigation if the statement is:

- Identified as a forward-looking statement and accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially;[221] or
- Immaterial.[222]

The PSLRA Safe Harbor does not specifically say so, but both alternatives for the first safe harbor should be viewed as dealing with materiality.[223] If a misstatement or omission is immaterial, there can be no private securities fraud liability. The first alternative—including meaningful cautionary statements—renders immaterial any inaccuracies associated with the forward-looking statements because the forward-looking statements must be viewed in context. Meaningful cautionary language would cause a reasonable investor not to attach too much significance to the forward-looking information, since the investor has been warned of important factors that could cause actual results to differ materially. The second alternative—"immaterial" statements—is not meant to duplicate the first alternative.[224] Instead, it is meant "to underscore that a forward-looking statement might be immaterial for reasons other than its having been qualified by meaningful cautionary statements. One example is a forward-looking statement—entirely unqualified by cautions—that is immaterial because it is mere puffery."[225]

Issuers typically rely on the meaningful-cautionary-statements alternative. This alternative involves important interpretation issues, primarily[226] focusing on what qualifies as a "meaningful" cautionary statement.[227] An issuer need not identify the precise risk that ultimately

[221] Securities Act § 27A(c)(1)(A)(i), 15 U.S.C. § 77z-2(c)(1)(A)(i); Exchange Act § § 21E(c)(1)(A)(i), 15 U.S.C. § 78u-5 (c)(1)(A)(i).
[222]Securities Act § 27A(c)(1)(A)(ii), 15 U.S.C. § 77z-2(c)(1)(A)(ii); Exchange Act § 21E(c)(1)(A)(ii), 15 U.S.C. § 78u-5(c)(1)(A)(ii).
[223] *See* Horwich, *supra* note 213, at 526.
[224] *See id*.
[225] *See id*.
[226] Richard A. Rosen & Jessica S. Carey, *The Safe Harbor for Forward-Looking Statements after Twenty Years*, 30 INSIGHTS: THE CORP. & SEC. L. ADVISOR 8, 12 (2016).
[227] *See, e.g.*, Institutional Inv. Grp. v. Avaya, Inc., 564 F.3d 242, 256 (3d Cir. 2009) ("[T]he cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge") (quoting Semerenko

caused the forward-looking information to be inaccurate.[228] However, overly broad risk disclosures that resemble boilerplate language are not sufficient.[229]

ii. Second Safe Harbor—No Actual Knowledge of Falsity

The second safe harbor immunizes forward-looking statements from private litigation if the plaintiff fails to prove that the person or entity who made the forward-looking statement did so with actual knowledge that it was false or misleading.[230] The language of section 27A and section 21E states the second safe harbor is an alternative immunity provision to the first safe harbor. In *Slayton v. American Exp. Co.*,[231] the Second Circuit wrote:

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v. Cendant Corp., 223 F.3d 165, 182 (3d Cir. 2000) (quoting *In re* Trump Casino Sec. Litig., 7 F.3d 371, 372 (3d Cir. 1993); Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 372 (5th Cir. 2004) ("The requirement for 'meaningful' cautions calls for 'substantive' company-specific warnings based on a realistic description of the risks applicable to the particular circumstances.").

[228] PSLRA Conf. Rep., *supra* note 16, at 44 ("Failure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor."); *See also In re* Harman Int'l Indus., Inc. Sec. Litig., 791 F.3d 90, 103 (D.C. Cir. 2015) which stated:

> Because Congress required that cautionary statements warn of "important factors that could cause actual results to differ," the cautionary language need not necessarily "mention *the* factor that ultimately belies a forward-looking statement." . . . That is, Congress did not require the cautionary statement warn of "*all*" important factors, so long as "an investor has been warned of risks of a significance similar to that actually realized," such that the investor "is sufficiently on notice of the danger of the investment to make an intelligent decision about it according to her own preferences for risk and reward." . . . Perfect clairvoyance may be impossible because of events beyond a company's control of which it was unaware.

[229] PSLRA Conf. Rep., *supra* note 16, at 43:

> [B]oilerplate warnings will not suffice as meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the statement. The cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement, such as, for example, information about the issuer's business. *Id.*

See also In re Harman Intern. Industries, Inc. Sec. Litig., 791 F.3d at 102:

> [M]ere boilerplate—"This is a forward-looking statement: caveat emptor," . . . does not meet the statutory standard because by its nature it is general and ubiquitous, not tailored to the specific circumstances of a business operation, and not of "useful quality," . . . So too, generalized warnings that forward-looking statements are "not guarantees of future performance . . . and involve known and unknown risks and other factors that could cause actual results to be materially different from any future results expressed or implied by them," . . . because such a statement is not specific regarding the business at issue. *Id*.

[230] Securities Act § 27A(c)(1)(B), 15 U.S.C. § 77z-2(c)(1)(B); Exchange Act § 21E(c)(1)(B), 15 U.S.C. § 78u-5(c)(1)(B).

[231] Slayton v. American Exp. Co., 604 F.3d 758 (2d Cir. 2010).

> The safe harbor is written in the disjunctive; that is, a defendant is not liable if the forward-looking statement is identified and accompanied by meaningful cautionary language *or* is immaterial *or* the plaintiff fails to prove that it was made with actual knowledge that it was false or misleading.[232]

That means that a defendant would not be liable if it failed to include meaningful cautionary language but lacked actual knowledge of falsity. It also means that a defendant would not be liable if it included meaningful cautionary language even though it had knowledge of actual falsity. Despite the statutes' clear language, some courts have reduced the distinct immunities into a single safe harbor, "essentially reading 'or' to mean 'and.'"[233] For example, in *Lormand v. US Unwired, Inc.*,[234] the Fifth Circuit held that the PSLRA Safe Harbor is inapplicable if the defendants actually knew that their statements were misleading.[235] The court transformed the lack-of-knowledge prong "from a sufficient to a necessary condition for immunity."[236]

b. Oral Statements

Unlike Rules 175 and 3b-6, the PSLRA Safe Harbor is not limited to statements made in SEC filings. The PSLRA Safe Harbor can apply to any written statement[237] (including, for example, press releases), as well as to oral statements.[238] Oral forward-looking statements can be immunized with meaningful cautionary statements if accompanied by an oral warning that actual results could differ materially from the projected results and that warning is accompanied by an oral statement directing listeners to a readily available written document, such as a Form 10-K or Form 10-Q, that contains the meaningful cautionary statements.[239]

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[232] *Id.* at 766.
[233] Doug Greene, *Is the Reform Act's Safe Harbor Truly Safe?*, D&O DISCLOSURE (May 16, 2022), https://www.dandodiscourse.com/2022/05/16/is-the-reform-acts-safe-harbor-truly-safe/.
[234] Lormand v. US Unwired, Inc., 565 F.3d 228 (5th Cir. 2009).
[235] *Id.* at 244.
[236] Rosen & Carey, *supra* note 226, at 18.
[237] The safe harbors in Securities Act § 27A(c)(1), 15 U.S.C. § 77z-2(c)(1), and Exchange Act § 21E(c)(1), 15 U.S.C. § 78u-5(c)(1), do not limit the protections to statements made in SEC filings.
[238] Securities Act § 27A(c)(2), 15 U.S.C. § 77z-2(c)(2); Exchange Act § 21E(c)(2), 15 U.S.C. § 78u-5(c)(2).
[239] Securities Act § 27A(c)(2)(A) and (B), 15 U.S.C. § 77z-2(c)(2)(A) and (B); Exchange Act § 21E(c)(2)(A) and (B), 15 U.S.C. § 78u-5(c)(2)(A) and (B). The cautionary statements contained in the written document must satisfy the requirements of the PSLRA Safe Harbor. Securities Act § 27A(c)(2)(B)(iii), 15 U.S.C. § 77z-2(c)(2)(B)(iii); Exchange Act § 21E(c)(2)(B)(iii), 15 U.S.C. § 78u-5(c)(2)(B)(iii).

c. Forward-Looking Statements Made in Connection with IPOs are Excluded

The PSLRA Safe Harbor contains several exclusions.[240] It excludes from its protections forward-looking statements made by certain disqualified issuers[241] or made in connection with certain disqualified transactions (e.g., tender offers[242] or going-private transactions[243]). The important exclusion for this article is the IPO conclusion. The PSLRA Safe Harbor does not immunize forward-looking statements "made in connection with an initial public offering."[244]

d. Discovery Stay Reduces Litigation Risk

The PSLRA Safe Harbor does more than just address a defendant's liability risk. It also reduces defendants' litigation risk by providing them with a discovery stay. Having a pathway to early, pre-discovery dismissal is key for defendants to lower their litigation risk, and the PSLRA Safe Harbor provides such a pathway. If a defendant moves for summary judgment based on the PSLRA Safe Harbor, the court must stay discovery (other than discovery specifically directed to the applicability of the safe harbor) during the pendency of the motion.[245] The PSLRA Safe Harbor's discovery stay provides defendants with a substantial advantage over the bespeaks caution doctrine. Varant Yeparian and Jon Janes explain:

> The discovery stay has important practical benefits. It enables a defendant to avoid the costs of written discovery, depositions, discovery motion practice, and the like. It also prevents plaintiffs from generating leverage by aggressively pursuing discovery in the hopes of obtaining a key admission or document and thus pressuring a defendant into settlement. Stopping discovery lessens a defendant's exposure as they need not be worried about harmful admissions or disclosure made through the discovery process.[246]

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[240] Securities Act § 27A(b), 15 U.S.C. § 77z-2(b); § 21E(b), 15 U.S.C. § 78u-5(b)..
[241] Securities Act § 27A(b)(1)(A)(i) and (ii), 15 U.S.C. § 77z-2(b)(1)(A)(i) and (ii); Exchange Act § 21E(b)(1)(A)(i) and (ii), 15 U.S.C. § 78u-5(b)(1)(A)(i) and (ii).
[242] Securities Act § 27A(b)(2)(C), 15 U.S.C. §77z-2(b)(2)(C); Exchange Act § 21E(b)(2)(C), 15 U.S.C. § 78u-5(b)(2)(C).
[243] Securities Act § 27A(b)(1)(E), 15 U.S.C. § 77z-2(b)(1)(E); Exchange Act § 21E(b)(1)(E), 15 U.S.C. § 78u-5(b)(1)(E).
[244] Securities Act § 27A(b)(2)(D), 15 U.S.C. § 77z-2(b)(2)(D); Exchange Act § 21E(b)(2)(D), 15 U.S.C. § 78u-5(b)(2)(D).
[245] Securities Act § 27A(f), 15 U.S.C. § 77z-2(f); Exchange Act § 21E(f), 15 U.S.C. § 78u-5(f).
[246] Varant Yegparian & Jon Janes, *Are SPACs Going to Lose Their Safe Harbor?*, SCHIFFER HICKS JOHNSON PLLC: INSIGHTS (Aug. 4, 2021), https://shjlawfirm.com/2021/08/04/are-spacs-going-to-lose-their-safe-harbor/.

Receiving immunity under the PSLRA Safe Harbor is not always an easy task for defendants. One commentator suggests that "some judges think the Reform Act goes too far, so they go to great lengths to avoid the statute's plain language."[247] Courts applying the lack-of-knowledge prong as a condition for the meaningful-cautionary-statement safe harbor is an example of that behavior. While this article is arguing for a pathway for IPO issuers to obtain PSLRA Safe Harbor protection, readers should not believe the PSLRA Safe Harbor is a panacea. It has its challenges. However, regardless of any such potential challenges, the discovery stay provides defendants with an important protection that generally reduces defendants' defense costs and liability. The discovery stay should be a very important consideration for defendants when they conduct their cost-benefit analysis to determine whether to voluntarily disclose forward-looking information.

There is no such discovery stay for cases defended using the bespeaks caution doctrine. When IPO issuers and their underwriters do their cost-benefit analysis, they must incorporate the higher defense costs and greater liability risk that come from more exposure to discovery. This factor, more than any other, likely explains why IPO issuers generally avoid including management forecasts in their IPO disclosure documents.

III. THE ABILITY TO DIFFERENTIATE HONEST FORECASTERS FROM DISHONEST FORECASTERS IS KEY TO THE PSLRA SAFE HARBOR

Should federal policy make it easier for IPO issuers to publish management forecasts? As explained earlier, a stock's intrinsic value depends on the issuer's ability to generate future free cash flows. A thoughtful valuation analysis simply cannot be accomplished without reasonable forecasts of the issuer's future financial performance, and the issuer's management should have better information about such future performance than prospective investors. Because IPO issuers tend to be younger companies with limited track records and highly uncertain futures, the information asymmetries regarding their future performance are particularly acute. Mitigating this information problem would make for a more informationally efficient IPO market that would allow investors to better differentiate between higher-quality issuers (and give them higher valuations) and lower-quality issuers (and give them lower valuations).

IPO issuers could potentially mitigate the problem by voluntarily disclosing management forecasts, but that solution raises the concern of management bias and managers' incentive to publish overly aggressive forecasts. Whether voluntary disclosure of management forecasts helps mitigate the information asymmetry problem ultimately depends on the forecasts', and the forecasters', credibility. If investors can differentiate

[247] Greene, *supra* note 233.

honest forecasters from dishonest forecasters, management forecasts can reduce the information asymmetries. Investors can give weight to forecasts from honest forecasters and use those forecasts for their investment decisions and significantly discount (or even ignore) forecasts from dishonest forecasters. However, if investors cannot make that differentiation, encouraging management forecasts is likely to worsen information asymmetries by increasing the amount of false and misleading information in the market.

An honest forecaster refers to an issuer that makes good faith, conservative forecasts rather than purposefully exaggerated ones. Being an honest forecaster does not mean the management forecasts will be perfectly accurate. Predicting the future is inherently difficult and management forecasts will always suffer from a high level of inaccuracy. However, honest forecasters try to be conservative with their estimates rather than purposefully overestimate their future performance.

Legal liability for misleading disclosures is federal securities law's main tool for promoting honest disclosure. However, as noted in Part II, anti-fraud liability may not be ideal for forecasts due to hindsight bias and the costly litigation risk that stems from stockholder strike suits. Rather than improve disclosure credibility, the anti-fraud system appears to discourage management-forecast disclosure altogether. Thus, it is not surprising that the PSLRA Safe Harbor opts to take a different approach to the credibility problem. Despite the risk of self-serving disclosure, the PSLRA Safe Harbor shields seasoned, public issuers from liability for forward-looking information. Instead of imposing a liability cost on dishonest disclosure, the PSLRA Safe Harbor places the burden on investors to differentiate honest forecasters from dishonest forecasters. The approach works because seasoned, public companies have a disclosure track record, and they develop disclosure reputations. Investors can evaluate the quality of an issuer's past disclosures to determine whether the issuer is honest or dishonest. When coupled with the PSLRA Safe Harbor's other protections (e.g., meaningful cautionary statements) and the SEC's guidelines for formulating and disclosing forecasts, investors should be able to thoughtfully absorb the potentially valuable information that comes from management forecasts while protecting themselves from the bias risk.

Because IPO issuers do not have disclosure track records, they lack disclosure reputations. Investors cannot simply evaluate IPO issuers' past disclosures to determine whether they are more likely to be honest forecasters that generate reasoned estimates or dishonest forecasters that are prone to self-serving, exaggerated estimates. Therefore, a different mechanism is needed for differentiating honest forecasters from dishonest ones. Absent such a mechanism, the SEC's choice to continue to exclude IPOs from the PSLRA Safe Harbor is reasonable.

IV. EXTENDED LOCKUP PERIODS CAN BE CREDIBLE SIGNALS FOR HONEST FORECASTERS

A mechanism does exist for differentiating IPO issuers that are honest forecasters from those that are not. Signaling theory can be used to identify honest forecasters. Specifically, extended stockholder lockups can serve as a highly credible *signal* that an IPO issuer's management forecasts are honest and, therefore, worthy of the PSLRA Safe Harbor's protections.

A. Signaling Theory

Signaling theory is used to understand behavior when two parties to a transaction have access to different information.[248] Sellers (also referred to as "signalers") may have important information about the quality attributes of their products or services that are not easily observable[249] by buyers (also referred to as "receivers").[250] If this information asymmetry is not resolved, buyers cannot distinguish high-quality sellers from low-quality sellers. Sellers can declare their quality to buyers, but buyers have no reason to take such self-serving declarations at face value. Sellers need another way to communicate their unobservable quality attributes, so they *signal* their quality to buyers. A "signal" is a costly, observable action that correlates with the unobservable quality.[251] As such, it serves as an informational cue from the signaler to the receiver.[252]

In his seminal article on signaling theory, Michael Spence developed a model for job candidates signaling their quality to potential employers.[253] Prospective employers want information about job candidates to decide who to hire and how much to pay them. The job candidates' verbal declarations about their quality are insufficient since they have incentives to exaggerate or lie. However, job candidates can signal their quality by obtaining costly education credentials. The credentials allow high-quality job candidates to distinguish themselves and obtain better jobs. Spence's "work triggered an enormous volume of literature applying signaling

[248] Brian L. Connelly, S. Trevis Certo, R. Duane Ireland & Christopher R. Reutzel, *Signaling Theory: A Review and Assessment*, 37 J. MGMT. 39, 39 (2011).
[249] Easily observable qualities are those that buyers can directly observe, or measure. Unobservable (or difficult to observe) qualities are those that buyers cannot directly observe or measure. For example, a buyer wishes to acquire a five-year-old, used pickup truck. The buyer wants the truck to be red and also dependable. The buyer can directly observe that the vehicle is a pickup truck, five years old, and red. However, whether the truck will be dependable is not readily observable. Applied to IPO issuers, whether an IPO issuer manufactures widgets is an easily observable quality. Whether an issuer is an honest forecaster is an unobservable quality.
[250] Connelly et al., *supra* note 248, at 42, 44–45.
[251] *Id.* at 45, 53–54.
[252] Saud A. Taj, *Application of Signaling Theory in Management Research: Addressing Major Gaps in Theory*, 34 EUR. MGMT. J. 338, 339 (2016).
[253] Michael Spence, *Job Market Signaling*, 87 Q. J. ECON. 355 (1973).

theory to selection scenarios that occur in a range of disciplines from anthropology to zoology."[254]

Signals play an important role in the financial markets. Financial investors need tools to help differentiate high-quality issuers from low-quality issuers—particularly when investing in younger, less-established companies—and signals provide such a tool. For example, an entrepreneur's willingness to invest in her own firm signals quality to potential investors ("The value of the firm increases with the share of the firm held by the entrepreneur.").[255] A private issuer with venture capital investors signals quality to the IPO market, evidenced by, among other things, a reduction in IPO underpricing, a better ability to attract more prestigious auditors and underwriters, and greater interest from institutional investors during the IPO.[256] Having prestigious underwriters signals quality to potential investors in IPOs[257] and follow-on offerings.[258]

A signal's usefulness depends on how strongly it correlates with the signaler's unobservable quality.[259] Having prestigious underwriters (e.g., Goldman Sachs) signals an issuer is high-quality because those prestigious underwriters have track records of underwriting successful offerings. Economists refer to this correlation as *signal fit*, and the stronger the fit, the more useful the signal.[260]

Signals must be both *observable* and *costly* to be effective.[261] A signal cannot communicate information to receivers unless they can observe it.[262] The reason that signals are such a powerful tool for the financial markets is "precisely because they are easier to discern than company quality."[263] A signal must also be costly. It must be profitable for high-quality parties to undertake the signal's cost but unprofitable for low-quality parties to do so. Low-quality parties will almost certainly want to imitate the signal and falsely pose as high-quality parties. The signaling costs must be sufficiently higher for low-quality parties that it does not make sense for them to do that.[264] Brian Connelly, Trevis Certo, Duane Ireland, and Christopher Reutzel offer the following explanation:

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[254] Connelly et al., *supra* note 248, at 40.
[255] Leland & Pyle, *supra* note 100, at 372.
[256] William L. Megginson & Kathleen A. Weiss, *Venture Capitalist Certification in Initial Public* Offerings, 46 J. FIN. 879, 880 (1991).
[257] Richard Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 J. FIN. 1045, 1046 (1990).
[258] Abe Helou & Gonyung Park, *Is There a Signaling Effect of Underwriter Reputation?*, 24 J. FIN. RSCH. 27, 42 (2001).
[259] Connelly et al., *supra* note 248, at 53.
[260] *Id.* at 52–53.
[261] *Id.* at 45.
[262] *Id*.
[263] Darian M. Ibrahim, *Crowdfunding Signals*, 53 GA. L. REV. 197, 206 (2018).
[264] Connelly et al., *supra* note 248, at 45.

> [S]ome signalers are in a better position than others to absorb the associated costs. The costs associated with obtaining ISO9000 certification, for example, are high because the certification process is time consuming, and these costs make cheating, or false signaling, difficult. However, ISO9000 certification is less costly for a high-quality manufacturer as compared with a low-quality manufacturer because a low-quality manufacturer would be required to implement considerably more change to be awarded the certification. If a signaler does not have the underlying quality associated with the signal but believes the benefits of signaling outweigh the costs of producing the signal, the signaler may be motivated to attempt false signaling. If this were to happen, misleading signals would proliferate until receivers learn to ignore them. Thus, to maintain their effectiveness, the costs of signals must be structured in such a way that dishonest signals do not pay.[265]

B. Using Extended Lockups as a Signal

IPO-issuer honesty is just the type of unobservable quality that signaling theory helps to address. Insiders know more about the IPO issuer's forecasting honesty than investors. Honest forecasters want to communicate useful information about an issuer's future performance to allow investors to better value the opportunity. Dishonest forecasters want to hype the stock so they can cash out their shares. Stockholder lockups with extended lockup periods can serve as a credible signal for distinguishing honest from dishonest forecasters because the extended lockup prevents the Insiders from cashing out their shares until a substantial period of actual results has been revealed.[266]

To understand the signaling capacity of extended stockholder lockups, it is useful to begin with a brief overview of standard stockholder lockups.

1. Standard Lockup Terms

When an issuer conducts an IPO, the underwriters typically negotiate lockups with the issuer's stockholders. Stockholder lockups are private contractual arrangements whereby the stockholders agree not to sell their issuer stock during the lockup period.[267] A standard lockup's primary function is to delay the price pressure that could come from having a surplus of stock come into the market before it stabilizes. Because lockups

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[265] *Id.*
[266] *See* Beng Soon Chong & Kim Wai Ho, *Lockup and Voluntary Earnings Forecast Disclosure in IPOs*, 36 FIN. MGMT. 63, 63–64 (2007).
[267] *See* Pinedo & Castillo, *supra* note 24, at 1. *See also Understanding Lock-Up Agreements*, *supra* note 24.

are not required by law, they have evolved as a matter custom and practice. As a result, there can be variations among such agreements. The following is meant to provide readers with a general idea of typical stockholder lockup provisions for IPOs.[268]

- **Lockup period.** The "lockup period" runs from the date the lockup is signed until 180 days after pricing.[269]
- **Locked-up stockholders.** Substantially all the pre-IPO stockholders are locked up.[270] Directors, officers, any selling stockholders, and any large stockholders (what this article collectively refers to as Insiders) will almost certainly be locked up. Shares sold in the IPO through a directed share program[271] are also typically locked up.[272]
- **Locked-up shares.** The lockup covers shares of the issuer's common stock and any securities convertible into or exercisable or exchangeable for the issuer's common stock (collectively, "locked-up shares").[273]
- **Restrictions.** The locked-up stockholders agree not to dispose of their locked-up shares during the lockup period. They may not offer, pledge, or grant any option or right to purchase or otherwise dispose of their locked-up shares.[274] They also may not engage in any hedging or similar transactions (including shorting the stock) that transfer the economic consequences of owning their shares.[275]
- **Carveouts.** Underwriters generally allow for several carveouts to the lockup restrictions. Most of the carveouts focus on financial and estate planning transfers. For example, lockup agreements frequently allow transfers as bona fide gifts, transfers to family trusts, transfers by will or intestacy to family members, and transfers pursuant to a divorce settlement.[276] Additionally, shares bought by locked-up stockholders in the open market after the IPO

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268 Stockholder lockups are also commonly employed for follow-on offerings, and their terms can differ substantially from stockholder lockups for IPOs. *See* Pinedo & Castillo, *supra* note 24, at 2; *Understanding Lock-Up Agreements*, *supra* note 24. This article's description of stockholder lockups, however, is limited to stockholder lockups for IPOs.
269 Pinedo & Castillo, *supra* note 24, at 1.
270 *Id*. at 2.
271 A directed share program allows an IPO issuer to reserve a percentage of the IPO offering for eligible participants (typically, directors, officers, employees and their relatives, and other designated friends of the issuer, such as vendors and suppliers). MORRISON FOERSTER, *The Short Field Guide to IPOs* 13 (2017), https://media2.mofo.com/documents/171116-ipo-field-guide.pdf. The size of the directed share program may be 5 to 10 percent of the of the total shares offered in the IPO. *Id.*
272 Pinedo & Castillo, *supra* note 24, at 2.
273 *Id*. at 1.
274 *Id*. at 2.
275 *Id.*; *Understanding Lock-Up Agreements, supra* note 24.
276 Pinedo & Castillo, *supra* note 24, at 2; *Understanding Lock-Up Agreements*, *supra* note 24.

usually may be sold (unless the sale requires an Exchange Act section 16(a)[277] filing to report a beneficial ownership reduction).[278]

- **Lockup Releases.** The lead underwriter generally has the discretionary right to release parties from the lockup agreement.[279]

2. Lockups Can be Credible Signals of Forecasting Honesty

Lockups correlate with an IPO issuer's unobservable quality of being an honest forecaster. They do so because they partially offset the Insiders' opportunistic desire to furnish exaggerated forecasts. Insiders can benefit from exaggerated forecasts. If believed, exaggerated forecasts increase the IPO issuer's stock price and, thus, increase the Insiders' personal wealth. Lockups partially offset that incentive because the Insiders must remain committed to the issuer until a period of actual results has been revealed.[280] The market tends to punish issuers that fail to achieve projected results.[281] If an IPO issuer's performance negatively aligns with its management forecasts during the lockup period, Insiders can expect to lose wealth due to the price drop on their locked-up shares. That wealth loss should more than offset the wealth gain Insiders initially received from exaggerating the forecasts.

The lockup makes a hostage of the Insiders' wealth that they only recover by meeting expectations until the lockup expires. IPO issuers with stockholder lockups, therefore, have an incentive to be conservative (i.e., honest) with their management forecasts. The longer the lockup period, the better the signal fit.[282] Insiders have a stronger incentive to be conservative with management forecasts when the lockup period is longer. If only three months of actual results will be published during the lockup period, the management forecasts only need to be conservative for one quarter. If nine or twelve months of actual results will be published during the lockup period, the management forecasts must be conservative for a more meaningful amount of time.

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[277] 15 U.S.C. § 78p(a).
[278] Pinedo & Castillo, *supra* note 24, at 2; *Understanding Lock-Up Agreements*, *supra* note 24.
[279] Pinedo & Castillo, *supra* note 24, at 2; *Understanding Lock-Up Agreements*, *supra* note 24.
[280] *See* Chong & Ho, *supra* note 266, at 63–64.
[281] *See, e.g.*, Bill Stone, *Earnings Are Supportive Of Stocks But Misses Are Punished*, FORBES (Feb. 6, 2022), https://www.forbes.com/sites/bill_stone/2022/02/06/earnings-are-supportive-of-stocks-but-misses-are-punished/?sh=7ad8a27e2554; Bailey Lipschultz, *Market Whiplash Proves It's A Terrible Time to Miss on Earnings*, BLOOMBERG (May 6, 2022), https://www.bloomberg.com/news/articles/2022-05-06/market-whiplash-proves-it-s-a-terrible-time-to-miss-on-earnings.
[282] *See* Chong & Ho, *supra* note 266, at 64.

Because stockholder lockups have signal fit, they can be effective signals if they are both observable and sufficiently costly. Observability is not an issue because the stockholder lockups are publicly disclosed in the prospectus and standard forms of the lockups are filed as exhibits to the S-1 registration statement.[283]

The key issue, therefore, is whether the lockups are sufficiently costly to differentiate honest forecasters from dishonest forecasters. Lockups impose a cost on Insiders. The cost stems from the length and rigidity of the lockup. Because the locked-up shares cannot be readily sold, they are illiquid. Illiquidity imposes a cost on Insiders due to the opportunity cost that comes from not being able to trade immediately.[284] Longer and less flexible lockups result in more illiquidity and a higher cost. Importantly, the opportunity cost is lower for Insiders who are confident in the IPO issuer's management forecasts. If Insiders are confident the IPO issuer will meet expectations during the lockup period, they bear less risk of the market punishing the issuer's stock price for failing to achieve projected results. If Insiders lack confidence in the management forecasts, their risk—and consequently their opportunity cost—from not being able to sell is higher. This cost differentiation is critical for lockups serving as credible signals because, at a certain point it will become too expensive for Insiders who lack confidence in management forecasts to agree to a lockup, thus preventing them from signaling their IPO issuers' honesty.

3. Standard Lockups are Not Credible Signals

Standard lockups do not serve as credible signals for whether an IPO issuer is an honest forecaster because the lockup period is too short. The short time frame results in weak signal fit and insufficiently high costs for the signalers. With the standard lockup, the IPO issuer only publishes one quarter of actual results before the lockup period expires.[285] Because it is easy to prepare forecasts to meet three-months of expectations, the standard lockup does not provide much of an incentive to discourage aggressive forecasts. The IPO issuer need only wait one quarter before showing overly aggressive growth. Knowing management forecasts are likely honest for only the first three months of the forecast is not much of a signal; the action communicates little about the IPO issuer's honesty and the overall credibility of its management forecasts.

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[283] *See* Pinedo & Castillo, *supra* note 24, at 1.
[284] *See* INVESTMENT VALUATION, *supra* note 40, at 683–84.
[285] Reporting companies report their quarterly results via a Form 10-Q. 17 C.F.R. § 249.10-Q. During at least the first year after the IPO, the issuer must file its Form 10-Q within 45 days after the end of the quarter. Form 10-Q, General Instruction A.1.b. Ninety days plus 45 days equals 135 days, and there is not room for two 135-day periods during a single, six-month period.

At the same time, the standard lockup is insufficiently costly to differentiate honest forecasters who truly believe in their forecasts from dishonest forecasters. We know the standard lockup is not sufficiently costly because almost all IPOs include standard lockups.[286] Even when IPO issuers fail to publish management forecasts, Insiders bear the idiosyncratic risk of their IPO-issuer shares during the lockup period. Almost all Insiders are currently willing to incur such opportunity cost for the standard lockup, so it does not allow for any differentiation.

4. Establishing a Credible Extended Lockup Signal

Extended lockups can be effective signals if they are long enough. As the lockup period extends, more actual results are published before Insiders can sell. Table 2 sets forth the actual results that would be published for a fictional IPO issuer assuming different lockup periods. Table 2 assumes the lockup period starts on January 15, and the issuer reports on a calendar year basis. Reporting companies report their quarterly results via a Form 10-Q[287] and their annual results via a Form 10-K.[288] During at least the first year after the IPO, the issuer must file its Form 10-Q within 45 days after the end of the quarter[289] and its Form 10-K within 90 days after the end of the year.[290]

[286] Annica Woolley, *IPO Lockups: Overview and Exceptions*, IPOHUB (Feb. 2, 2022), https://www.ipohub.org/ipo-lockups-overview-and-exceptions/.
[287] 17 C.F.R. § 249.308a.
[288] 17 C.F.R. § 249.310.
[289] Form 10-Q, General Instruction A.1.b.
[290] Form 10-K, General Instruction A(1)(2)(c).

Table 2
Actual Results Published Assuming Different Lockup Periods
(assumes the issuer reports on a calendar year basis)

Lockup Period (starts on Jan. 15)	**Expiration of Lockup Period**	**Actual Results Published During Lockup Period**	**First Results Published After Lockup Period**
6 months	July 15	1st quarter Form 10-Q (filing deadline of May 15)	2nd quarter Form 10-Q (filing deadline of Aug. 14)
7 months	August 15	1st quarter Form 10-Q (filing deadline of May 15) 2nd quarter Form 10-Q (filing deadline of Aug. 14)	3rd quarter Form 10-Q (filing deadline of Nov. 14)
8 months	September 15	1st quarter Form 10-Q (filing deadline of May 15) 2nd quarter Form 10-Q (filing deadline of Aug. 14)	3rd quarter Form 10-Q (filing deadline of Nov. 14)
9 months	October 15	1st quarter Form 10-Q (filing deadline of May 15) 2nd quarter Form 10-Q (filing deadline of Aug. 14)	3rd quarter Form 10-Q (filing deadline of Nov. 14)
10 months	November 15	1st quarter Form 10-Q (filing deadline of May 15) 2nd quarter Form 10-Q (filing deadline of Aug. 14) 3rd quarter Form 10-Q (filing deadline of Nov. 14)	Annual report on Form 10-K (filing deadline of Mar. 31)
11 months	December 15	1st quarter Form 10-Q (filing deadline of May 15)	Annual report on Form 10-K (filing deadline of Mar. 31)

		2nd quarter Form 10-Q (filing deadline of Aug. 14) 3rd quarter Form 10-Q (filing deadline of Nov. 14)	
12 months	January 15 next year	1st quarter Form 10-Q (filing deadline of May 15) 2nd quarter Form 10-Q (filing deadline of Aug. 14) 3rd quarter Form 10-Q (filing deadline of Nov. 14)	Annual report on Form 10-K (filing deadline of Mar. 31)
13 months	February 15 next year	1st quarter Form 10-Q (filing deadline of May 15) 2nd quarter Form 10-Q (filing deadline of Aug. 14) 3rd quarter Form 10-Q (filing deadline of Nov. 14)	Annual report on Form 10-K (filing deadline of Mar. 31)
14 months	March 15 next year	1st quarter Form 10-Q (filing deadline of May 15) 2nd quarter Form 10-Q (filing deadline of Aug. 14) 3rd quarter Form 10-Q (filing deadline of Nov. 14)	Annual report on Form 10-K (filing deadline of Mar. 31)
15 months	April 15 next year	1st quarter Form 10-Q (filing deadline of May 15)	1st quarter Form 10-Q (filing deadline of May 15)

	2nd quarter Form 10-Q (filing deadline of Aug. 14)
	3rd quarter Form 10-Q (filing deadline of Nov. 14)
	Annual report on Form 10-K (filing deadline of Mar. 31)

a. Length of Extended Lockup

To serve as an effective honesty signal, the extended lockup needs to be long enough to provide a strong incentive for conservative forecasts and long enough to generate sufficient costs to make false signaling unprofitable for dishonest forecasters. Finding a suitable lockup period may require some experimentation. If the lockup period is set correctly, it will be profitable for Insiders of honest IPO issuers to agree to the extended lockups, but not profitable for Insiders of dishonest IPO issuers.

- **Insiders of honest IPO issuers.** Their issuers would be able to publish PSLRA-Safe-Harbor-protected management forecasts, which would reduce information asymmetries and increase the issuer's share price. The Insiders would bear the cost of the extended lockups, but that cost would be less than their wealth increase from the increased share price because they bear less risk of the market punishing the issuer's stock price for failing to achieve projected results.
- **Insiders of dishonest IPO issuers.** Their issuers would also be able to publish PSLRA-Safe-Harbor-protected management forecasts, which would reduce information asymmetries and increase the issuer's share price. However, the Insiders' costs for the extended lockups would be too high. The Insiders of dishonest IPO issuers would bear substantial risk of the market punishing the issuer's stock price before the lockup expires at a level that more than offsets the initial wealth gain from the exaggerated forecasts. Agreeing to the extended lockups would, therefore, not be profitable.

This author suggests starting with a lockup period that requires Insiders to refrain from selling their shares until the IPO issuer has published a full-year of actual results. There are a few reasons for this suggestion. First, quarterly financial reporting on Form 10-Q is unaudited,[291] while annual financial reporting on Form 10-K is audited.[292] By requiring the IPO issuer to publish at least one year of results, the issuer will need to file a Form 10-K during the lockup period and provide one set of audited results before the lockup expires. Second, a full year of projections that are subject to a substantial honesty incentive (or the Insiders forfeit wealth) provides potential investors with a good starting point for projecting the IPO issuer's future financial performance. Investors do not expect perfect forecasts far into the future. In the case of analyst forecasts, recall from Part I that (a) analysts are more likely to generate short-term forecasts (e.g., two years or less) than long-term forecasts,[293] (b) analyst forecasting tends to be more accurate for shorter horizons and less accurate for longer horizons,[294] and (c) analysts are judged more critically on the accuracy of their short-term forecasts rather than their long-term forecasts.[295] The market is used to relying on short-term forecasts and should welcome management forecasts where management's incentives are closely aligned with investors' incentives for one year.

A lockup period that requires IPO issuers to publish one year of results could result in quite a lengthy lockup (e.g., 15 months). If the lockup period is too long and too expensive, no one will engage in the signaling activity, thus defeating the purpose of creating a credible signal. One possible solution would be to allow the lockup to gradually phase out after the IPO issuer has released some of its results. For example, after the IPO issuer has published six months of financial results, ten percent of the locked-up shares could be released from the lockup. After the IPO issuer has published nine months of financial results, an additional 15 percent could be released. Once again, this is not meant to be a definitive statement on the perfect cost for the extended lockups. However, the reasons for these choices are:

- **100-percent lockup until six months of results published.** Insiders' shares should be locked up tight through at least

[291] Form 10-Q's Item 1 directs issuers to provide the financial information required by Regulation S-X Rule 10-01, 17 C.F.R. § 210.10-01. However, if the issuer is a smaller reporting company (defined in Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2), then the issuer may provide the financial information required by Regulation S-X Rule 8-03, 17 C.F.R. § 210.8-03. Neither Rule 10-01 nor Rule 8-03 call for audited financial statements.
[292] Form 10-K's Item 8(a) directs issuers to file financial statements meeting the requirements of Regulation S-X. Article 3 of Regulation S-X calls for audited annual financial statements. Regulation S-X Item 3-01(a), 17 C.F.R. § 210.3-01(a); Regulation S-X Item 3-02(a), 17 C.F.R. § 210.3-02(a); and Regulation S-X Rule 3-04, 17 C.F.R. § 210.3-04. If the issuer is a smaller reporting company, Form 10-K's Item 8(b) allows the issuer to file financial statements meeting the requirements of Article 8 of Regulation S-X rather than the financial statements required by Item 8(a). Article 8 also calls for audited annual financial statements. Regulation S-X Item 8-02, 17 C.F.R. § 210.8-02.
[293] *See infra* note 73 and accompanying text.
[294] *See infra* note 74 and accompanying text.
[295] *See infra* note 75 and accompanying text.

two-quarters of published results. The idea behind the signal is that the Insiders have placed their wealth from owning the IPO issuer hostage until a meaningful period of results have been published to prove the IPO issuer's credibility. Multiple actual results should be published before considering granting Insiders any relief from the extended lockups.

- **10-percent release after six months of results published.** The idea would be to allow Insiders access to a small fraction of their ownership wealth in the IPO issuer. It is not uncommon for officers of IPO issuers to receive a lot of their compensation in the form of equity. They may want access to some of their wealth to upgrade their living situation, fund their children's education, or other everyday reasons. Insiders would be given a modicum of relief while the vast majority of their ownership wealth continues to be held hostage.
- **15-percent release after nine months of results published.** The reasoning behind this 15-percent release is the same as for the 10-percent release.

This author freely admits that he has no crystal ball for determining the optimal extended lockup period. However, the length of the lockup period is the key to lockups serving as credible signals. If the lockup period is too long (and too costly), nobody will submit to the lockups and no IPO issuers will be able to signal their forecasting honesty. If the lockup period is too short (and too inexpensive), Insiders of dishonest IPO issuers will also submit to the lockups and flood the market with false signals.

If the SEC embraces the idea of expanding the PSLRA Safe Harbor to IPO issuers with extended lockups, finding a suitable lockup period would need to be a major focus of the public comment process.

b. Additional Criteria for the Extended Lockups

The length of the lockup period is just one requirement for formulating lockups that can serve as effective honesty signals. Five additional questions must be addressed: (1) who should be locked up?; (2) what shares should be locked up?; (3) what restrictions should be placed on the locked-up shares?; (4) what carveouts are permissible?; and (5) what lockup releases are permissible? As with choosing the lockup period's length, the goal is to create a set of requirements that incentivize conservative forecasts and impose a cost that makes it unprofitable for Insiders of dishonest IPO issuers to agree to the lockups.

i. Stockholders Subject to the Extended Lockups

The extended lockups would not need to cover all the pre-IPO stockholders. To signal an IPO issuer's forecasting honesty, the extended lockups need to cover those stockholders who are likely to possess private information about the issuer's future performance. Thus, the extended lockups would need to apply to the IPO issuer's officers, directors, and important stockholders (the "Extended-Lockup Insiders"). Other stockholders, such as rank-and-file employees, would not need to enter into extended lockups for the signaling function to work.

This part of the proposal raises two definitional issues: (a) who qualifies as an officer?; and (b) who qualifies as an important stockholder? Different companies use officer titles differently. To come up with a definition that captures those individuals in the firm who are most likely to have the requisite private information, this author suggests using the definition of "executive officer" from Rule 501(f) of Regulation D of the Securities Act.[296] Rule 501(f) defines an "executive officer" as

> the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer. Executive officers of subsidiaries may be deemed executive officers of the issuer if they perform such policy making functions for the issuer.[297]

The Rule 501(f) definition captures the classic individuals one thinks of as officers—namely, the president, the chief financial officer, the chief sales officer, and the chief operating officer—and it also captures any other person who performs policy making functions for the issuer.

As for important stockholders, the idea is once again to capture stockholders who are likely privy to private information about the issuer's future performance. This author suggests defining the term to capture stockholders who own five percent or more of the IPO issuer's equity because five percent is a significant ownership percentage and likely entitles the stockholder to a close relationship with the issuer's management.

ii. Locked-Up Shares

The extended lockups should cover the same locked-up shares as a standard lockup. Namely, they would cover shares of the IPO issuer's common stock and any securities convertible into or exercisable or

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[296] 17 C.F.R. § 230.501(f).
[297] *Id*.

exchangeable for the issuer's common stock. This coverage should adequately make a hostage of the Extended-Lockup Insiders' ownership wealth from the IPO issuer.

iii. Restrictions

The restrictions on the extended lockups should also be similar to those in a standard lockup. The Extended-Lockup Insiders would need to agree not to dispose of their locked-up shares during the extended lockup period. They would also be prohibited from (a) offering, pledging, or granting any option or right to purchase or otherwise dispose of their locked-up shares or (b) engaging in any hedging or similar transactions (including shorting the stock) that transfer the economic consequences of owning their shares. The Extended-Lockup Insiders should not be allowed to do anything that allows them to reduce their idiosyncratic risk in the IPO issuer until after the extended lockup period expires.

iv. Carveouts

The carveouts can also follow the same approach as most standard lockups. Carveouts allowing certain financial and estate planning transactions (e.g., transfers as bona fide gifts, transfers to family trusts, transfers by will or intestacy to family members, and transfers pursuant to a divorce settlement) should not cause any problem. The extended lockups' goals is to force the Extended-Lockup Insiders to bear the IPO issuer's idiosyncratic risk during the lockup period. The carveouts for financial and estate planning are limited to intra-family transactions that preserve the spirit of the extended lockups' goals. Carving out shares bought by Extended-Lockup Insiders in the open market after the IPO would also be okay.

v. Lockup Releases

The final criterion is permissible lockup releases. With standard lockups, the lead underwriter can discretionarily release locked-up shares prior to expiration, and underwriters routinely engage in this practice.[298] Such discretionary underwriter lockup releases should be prohibited. As noted above, the primary function of standard lockups is to delay the price pressure that could come from having a surplus of stock come into the market before it stabilizes. Discretionary releases in that setting can be sensible, and they are sometimes tied to the issuer's stock price reaching a certain threshold. However, if the lockups are serving as an honesty signal, such early releases for Extended-Lockup Insiders make no sense and should be prohibited.

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[298] *See, e.g.*, Telis Demos, *A New Twist to Early 'Lockup' Release*, WALL ST. J. (Sept. 27, 2012, 7:54 PM), https://www.wsj.com/articles/SB10000872396390444549204578022610168042212 ("In the past four years, banks have allowed pre-IPO investors in 11% of all U.S.-listed IPOs to sell shares before lockups expired . . . ").

V. CONCLUSION

This article has sought to address one of the IPO market's most intractable problems: how to reduce the information asymmetry between IPO issuers and potential investors regarding the firm's future financial performance. The obvious solution of having IPO issuers voluntarily publish management forecasts in their IPO disclosure documents has not worked for a few reasons. To begin with, securities law's anti-fraud system is not well suited for distinguishing honest forecasters (whose forecasts turned out to be inaccurate) from dishonest forecasters, which creates an unacceptable risk of strike suits for IPO issuers. Federal policy could reduce that liability problem by immunizing management forecasts made in connection with IPOs from private litigation. However, IPO issuers have an incentive to overstate their future prospects. As a result, voluntary disclosure of management forecasts only mitigates the information asymmetry problem if investors can differentiate honest, conservative forecasters from aggressive forecasters.

Applying signaling theory, this article explains how extended lockups, if properly designed, can credibly signal that an IPO issuer is an honest forecaster that generates conservative estimates. Such honest-forecasting IPO issuers are worthy of the PSLRA Safe Harbor's immunity protections. This article's solution reduces information asymmetries for honest-forecasting IPO issuers by encouraging them to publish their management forecasts. IPO issuers that fail to comply with the extended-lockup requirement would continue to be excluded from the PSLRA Safe Harbor's protections, which would also reduce information asymmetries by identifying those issuers that are unwilling to pay the price to publish their forecasts.

The SEC has the statutory authority to implement this article's proposal. Securities Act section 27A(b)[299] and Exchange Act section 21E(b)[300] both include the following provision:

> Except to the extent otherwise provided by rule, regulation, or order of the Commission, this section shall not apply to a forward-looking statement . . . that is . . . made in connection with an initial public offering.

The SEC should use that rulemaking authority to extend the PSLRA Safe Harbor's protections to IPO issuers that submit to the extended lockups described herein. The SEC's historic hesitancy to expand the PSLRA Safe Harbor to cover IPOs and, thus, encourage IPO-issuer management forecasts is both understandable and reasonable. However, signaling theory

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[299] 15 U.S.C. § 77z-2(b).
[300] 15 U.S.C. § 78u-5(b).

and the extended lockups proposed in this article should address the SEC's concerns.

The key to this article's proposal is identifying the correct lockup period length. If the lockup period is too long (and too costly), nobody will submit to the lockups and no IPO issuers will be able to signal their forecasting honesty. If the lockup period is too short (and too inexpensive), Insiders of dishonest IPO issuers will also submit to the lockups and flood the market with false signals. As noted earlier, this author freely admits that he has no crystal ball for determining the optimal extended lockup period. The suggestion of an extended lockup period that would generally require Extended-Lockup Insiders to refrain from selling their shares until the IPO issuer has published a full year of actual results is just a suggestion. Maybe only nine-months of actual results would be sufficient. If the SEC embraces the idea of expanding the PSLRA Safe Harbor to IPO issuers with extended lockups, finding a suitable lockup period would need to be a major focus of the public comment process. Insights from IPO issuers, public investors, pre-IPO investors, underwriters, and securities lawyers would all be helpful for determining the optimal lockup period.