Regulating Forward-looking Information Disclosure in Chinese Securities Market---Past, Present and Future

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Abstract

Scholars in China and abroad have spilled much ink on regulation of information disclosure in Chinese securities market, and their collective wisdom and efforts have shed illuminating light on this fascinating topic. However, the previous literature tends to focus on disclosure of ‘factual information’, which mainly refers to events that have occurred to the company. Not much attention has been concentrated on the regulation of forward-looking information, which are the statements regarding company’s future performance. Because of the different natures of these two categories of information, the regulatory approach of forward-looking information presents a very different picture from that governing factual statement. This article expects to fill the vacuum of research in Chinese context. After first showing a picture of past regulations over forward-looking statements in China, it systematically examines and critically evaluates the present bewildering regulations that are scattered in an array of rules, regulations and standards with different hierarchies. Based on lessons and experiences gained from evolutions of legal norms governing forward-looking statements in the U.S, the article charts a path for China to build an appropriate regulatory framework. It is envisaged that with the further liberalization of Chinese financial market and ongoing reform of securities offering rules, both companies and investors will cast more attention on companies’ forward-looking information, thus it is a critical moment for Chinese regulator to seriously consider launching a reform of rules tackling this issue.

Keywords: forward-looking information; regulatory approach; Chinese securities market
I. Introduction

Information disclosure has been recognized as the cornerstone of modern securities regulation. Two categories may be classified based on information’s nature: ‘historical information’ and ‘forward-looking information’. The former mainly constitutes events that have occurred, the most familiar illustration of which may be the accounting-based information in company’s financial statements, reporting items such as the sales, expenses, and income produced from operation for a period. The later usually refers to the statements regarding future performance like earnings projections and business development plans.

From the lens of investors, they tend to make investment decisions not merely on issuers’ factual statement, rather more likely, on forward-looking information like projections of issuers’ future performance, since after all, the value of a security is nothing more than expectation of future streams of earnings that is discounted to the present value. Though other market participants, particularly securities analysts, also make projections of issuers’ future, issuers’ self-predictions are arguably more reliable due to issuers’ advantage to their insider information and experience of running own business. Besides its value in facilitating investors’ making more intelligent decisions, forward-looking disclosure may also well be understood as a mechanism to police

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1 For a discussion of evolution and debate of regulatory philosophies over the U.S securities market, see. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 32-45(5th ed. 2004).
4 See e.g., Homer Kripke, The SEC, the Accountants, Some Myths and Some Realities, 45 N.Y.U L.REV.1151, 1201 (1970). (stating that management’s estimates, administratively disciplined, would be of more value to investors and professionals than the raw facts)
5 John S. Poole, Improving the Reliability of Management Forecasts, 14 J. CORP.LAW. 547 (1989) (the forecasting process from both a legal and business lens)
6 See e.g., Bart A. Basi et al., A Comparison of the Accuracy of Corporate and Security Analyst, Forecasts of Earnings, 51 ACCOUNTING REVIEW. 244, 252 (1976) (concluding that there is reasonable evidence that company forecasts were better than analysts’ forecasts)
director and manager’s duty of care and fiduciary duty. As Professor Thompson and Sale innovatively asserted, Item 303 of Regulation S-K under U.S securities regulations realm mandating issuers to identify known trends or uncertainties that will result in material increase or decrease in liquidity can function as enforcement of duty of care, which requires managers to be concerned about liquidity and events related to those changes. 7 Meanwhile, the rule that managers shall indicate the course of action to take to remedy the deficiency once the trend is identified functionally amounts to fulfilling their duty of care, 8 the inherent connotation of which does demand managers to resolve or remedy any such deficiency. 9

Unlike factual information which can be verified at the moment of disclosure, the intrinsic uncertain nature of forward-looking information determines a different regulatory approach. On the one side, issuer’s concern that it would be exposed to increasing litigation risks just because of the deviation between actual performance and previous projections should be mitigated, so that issuer is to have more incentive and willingness to convey valuable forward-looking information to investors; while on the other, investors’ reasonable reliance on issuers’ projections should also be protected. Hence, any endeavor to regulate the disclosure of forward-looking statements is actually to achieve an equilibrium between these two competing interests.

8 Regulation S-K, item 303(a)(1). (articulating that if a material deficiency is identified, registrant shall indicate the course of action to take to remedy the deficiency. It shall also identify and separately describe internal and external sources of liquidity, and shall briefly discuss any material unused source of liquid assets)
9 Thompson & Sale, supra note 7, at 874.
Quite a number of law review articles have been dedicated to topic of forward-looking information disclosure in the U.S,\(^\text{10}\) while little attention has been focused on the same issue in China which cherishes a fledgling but globally attractive market. This article tries to fill this vacuum. Articles exploring the current issue may generally have two categories: the first tries to evaluate and design mechanism that can tread a balance between the above-mentioned competing interests. The second one is more close to insider trading regulation, focusing on whether and when forward-looking information, such as a M&A deal that is still under negotiation should be mandatorily disclosed so as not to violate insider trading prohibition.\(^\text{11}\) The article belongs to the first class, that is, concentrating on exploration of a balanced regulatory approach over forward-looking statements in issuer’s prospectus and periodic disclosures.

The balance of the article is structured as follows. Part II first presents a picture of past regulations over forward-looking statements in China. It is noted that, quite opposite to U.S securities regulation history where the SEC first took a quite conservative attitude towards such disclosure, projections were mandatorily required at the very beginning of growth of Chinese securities market. It is argued that this was not due to the Chinese regulator’s realization of the value of forward-looking information, it was rather largely affected by the old IPO selecting criteria and price determining mechanism. Part IV systematically examines the present bewildering regulations over forward-looking statements, which are scattered in an array of rules, regulations and standards with different hierarchies. This part tries to reveal the deficiencies in


current regulatory framework and these deficiencies have resulted in two extremes: on the one spectrum, some issuers are not willing to voluntarily disclose forward-looking statements due to the lack of safe harbor protection; while on the end, others may rather dare to disclose overly-optimistic or even misleading projections because of the lack of an efficient anti-fraud enforcement mechanism. Considering that U.S securities regulations currently cherish a well-practiced framework governing forward-looking information disclosure, Part V by drawing the lessons and experiences gained from evolutions of legal norms in the U.S, charts a path for China to build an appropriate framework over forward-looking statements. In conclusion part, it is envisaged that with the further liberalization of Chinese financial market and ongoing reform of securities offering rules, both companies and investors will cast more attention on forward-looking information, thus, it is the critical moment for Chinese regulator to seriously consider launching a reform of rules tackling this issue.

II: Past Regulatory Framework over Forward-Looking Information in China

The evolution of regulatory philosophy over forward-looking statements in China witnesses an incremental shifting from mandatory obligation to voluntariness. This process may be better understood as an epitome of the institutional change of price determination mechanism for public offering in Chinese securities market, since it is observed that the regulatory change to forward-looking statements has always occurred in tandem with government’s decision to formulate a new means to determine IPO price.

At the infancy stage of market development, two categories of forward-looking information were mandatorily required for companies applying for IPO: future business plan and earnings
projection. It may be worth of spilling some ink on the ‘intriguing’ requirement governing earnings projections, under which new applicants were not only obligated to disclose such projection in application materials as enshrined in Interim Provision on the Issuing and Trading of Stocks (hereinafter ‘Interim Provision’), arguably the first national-level regulation over China’s new-born stock market, but had to ensure the quantity of projected earnings to be beyond a statutorily minimum threshold, i.e. saving interest rates at the same period.

Paternalist regulatory philosophy adopted by the regulator may be easily discerned from these regulations. By setting a minimum level of earnings projections as a proxy to select promising companies to go listing, the government obviously intended to make investors feel assured that they would make money from stock market, or at worst gain some interests rates as if they have put the money in the bank. Understandably, considering the fact that the concept of ‘securities’ was totally alien to Chinese people who were more adaptive to save money rather than investing, impressing investors to hold such a belief was indeed necessary for the starting of China’s new stock market. However, regulatory authority’s expectation to enable investors to make money was not easily achieved in reality. Though a promising earnings projection may indicate a high probability for investors to make a ‘good deal’, given the speculative characteristics of China’s nascent stock market, trading price at the secondary market did not necessarily reflect issuers’ intrinsic value. Meanwhile, the applicant was obligated to disclose only next year’s earnings

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12 Article 15 of the Interim Provision lists the items that should be mandatorily included in the prospectus, among which Item 9 provides ‘The short-term development plan of the company and the documents for the prediction of the gains for the next year and certified registered accounts should be include in the prospectus’. Article 34 lists the items that are mandatorily required in the listing announcement, among which Item 5 also mandates the disclosure of issuer’s projection of next-year profits.

projection rather than a prediction of profit-making capacity in the near future, it is hard to assert that one-year prediction would be of much value for those long-term investors. Moreover, unlike disclosure-based regulatory philosophy adopted in western matured securities market, an array of different regulatory frameworks have been set to regulate securities offering, the common feature of which is that the regulatory body held the wide discretion in approving offering applications. One of the most demonstrable example is ‘quota system’ practiced from 1990-1999, under which centrally-planned annual numbers of offerings were assigned to the provinces and then the issuers should first get the quota from the local provincial government before their application materials could be submitted to the central regulator for reviewing.\textsuperscript{14} It is true to assert that the authority only considered offering applications from state-owned enterprises (SOEs) since the mission to establish a stock market in china was to rescue financially distressed SOEs and facilitate state’s transition from a planned economy to market-oriented one,\textsuperscript{15} fierce competitions nevertheless existed because too many SOEs were eagerly waiting for an admission ticket to enter stock market. Holding the perception that earnings projections as a proxy for applicant’s future was one vital factor in authority’s selection and approval process, in order to successfully attain the precious approval of public offering, it’s no wonder that applicants were always faced with a moral hazard: ‘packaging’ themselves as high-quality issuers through making exaggerating or even fraud earnings projections, the situation of which was further worsened by the lack of an effective anti-fraud regime at that period.

\textsuperscript{14} Another vivid example is the ‘He Zhun Zhi’ (merit-based review system or approval system) that was adopted after the abolition of ‘quota system’. Under this regime, the government no longer put a cap on the numbers of offerings allowed to be made each year, but rather, the regulatory body in theory could approve any offering applications it thought fit and reject any it thought unfit. See. Hui Huang, The Regulation of Securities Offerings in China: Reconsidering the Merit Review Element in Light of the Global Financial Crisis, 41 HONG KONG L.J. 261, 262-264 (2011). For an introduction of approval mechanism of IPO in Chinese securities market, also see. e.g., Alex K L Lau, A Study of Listing Applications in the People’s Republic of China, 28 COMPANY LAWYER. 90, 93 (2007); Liufang Fang, China’s Corporatization Experiment, 5 DUKE J.COMP&INT’L L. 149, 169 (1996).

\textsuperscript{15} Hui Huang, Ibid, at 263.
Besides its role played in affecting authority’s mind during approving process, earnings projection was moreover a key determinant in offering price. A so-called ‘P/E Ratio’ mechanism was chosen by the regulator as the means to figure out IPO price, under which the price was calculated by two indicators, namely ‘after-tax profit per share’ and ‘P/E ratio’(IPO price=‘after-tax profit per share’ times ‘P/E ratio’). Before 1996, the number of ‘after-tax profit per share’ was fixed by the ‘profits gained the year before offering’ and the ‘projected earnings of the offering year’. Obviously, the later forward-looking factor was more easily to be manipulated than the former historical fact (but of course, when the Chinese stock market was still at its infancy, even cooking ‘hard information’ was quite convenient). In that regard, what new issuers desiring to make ‘good’ use of this hard-attained golden opportunity would usually do is to exaggerate the ‘projected earnings of offering year’ with the purpose to ‘bubbling’ offering price and thus to raising much capital as it could.

Realizing this deficiency, the Chinese Securities Regulatory Commission (CSRC) issued a new Notice on Several Issues of Share Offering in 1996 (hereinafter ‘1996 Notice’), which detached the offering price from issuer’s earnings and articulated that the price should be determined by arithmetic mean value of profits after tax of last three years instead of the previous earnings projection. Changing the key IPO price determinant from forward-looking information (‘earnings projection’) to factual statement (‘last three-year average profits’) demonstrates regulator’s concern of issuer’s manipulating forecasts. Though ostensibly earning projection no

\[^{16}\text{Researching on Marketlisation of IPO Price Determination, available from: \url{http://www.ccepcc.com/jiji/jr/990285.htm} (last visited 5 June, 2011)}\]

\[^{17}\text{Ibid}\]

\[^{18}\text{1996 Notice, art.5.}\]
longer constituted an element determining the offering price, it didn’t necessarily mean a mitigated importance of such information from issuer’s perspective, because it still had the incentive to make this data look attractive so as to impress both regulator for approval of offering and investors for their money. Out of regulator’s expectation, attaching offering price to factual information gave rise to another form of manipulation, i.e. cooking corporate records and books to inflate profits that had been gained. For example, one of the most demonstrable scandals Chengdu Hongguang Inc, where the defendant issuer fraudulently substituted the fact of 103 million RMB losses with 54 million RMB profits for the sole aim to attaining IPO and listing qualification, did occur at this moment, representing the first criminalization of issuer’s directors and managers for fraudulent disclosure in Chinese securities market.19

Another noteworthy feature of this 1996 Notice lies in its explicit articulation of issuer’s liability arising from deviation between actual performance and earnings projection previously stated in the disclosures. Demanding the earnings projection to be audited by professional accountants, article 4 further attached two categories of liabilities according to the degree of deviation: if the actual earning is lower than the projection by 10-20%, then the issuer and its auditor should apologize to public and explain the failure to fulfill the estimated projection in CSRC’s designated media; while if the actual earning is lower than the projection by at least 20%, then plus to apology and explanation, an investigation led by the CSRC may be triggered to detect whether any fraud scheme had been involved in disclosure.20

19 For an introduction to this cornerstone case, see e.g., Guanghua Yu & Li Shao, Against Legal Origin: Of Ownership Concentration and Disclosure, 7 JOURNAL OF CORPORATE LAW STUDIES. 285, 300 (2007).
20 1996 Notice, art.4.
It is admitted that providing a clear rule of liability might act as an external pressure to propel issuers to make more reliable projections and fulfill them to its best ability. Though soft sanctions like apology or explanation usually means no future legal liabilities to be imposed and even CSRS’s investigation would not necessarily result in punishment, issuers may nevertheless bear extra burden and suffer negative impact like reputational damage. However, the drawback of this seemingly clear articulation of liability just lies in its ‘certainty’, because the more certain the line of liability is drawn, the more likely the regulated are prone to manipulate it. For example, it’s still possible for the issuer to narrow the deliberate exaggeration of earnings projection within 20% boundary if it figures out that the benefits of such overly optimistic projection outweigh the burden of apologizing and explaining.

The year of 1997 signifies a shifting of regulatory philosophy over earnings projection from a mandatory basis to a voluntarily disclosed item. As a concrete endeavor to institutionalize content and format of information disclosure, the CSRC issued its first version of ‘Standard for Contents and Formats of Information Disclosure No.1—IPO Prospectus’ in 1997 (hereinafter ‘1997 Standard No.1’), under which two main categories of forward-looking statements were regulated, namely earnings projection and issuer’s business outlook. Opposite to the previous mandatory approach, by using the word ‘may’, the regulator abandoned the previous ‘one-size-fits-all’ approach and left the right to disclose earnings projection on the hand of issuer, who may well put such information in the prospectus so long it holds the view that earnings projection would facilitate investors’ decision making and it does have the ability to make a reasonable projection of the near future. 21 Moreover, expecting the gatekeeper to play a monitoring function,

21 1997 Standard No.1, sec. 19. (titled ‘Profits Projections’)

the Standard further requires the projections to be duly audited by qualified accountants.\textsuperscript{22} While
in stark contrast to the voluntary nature of earnings projections, issuers were still under the
obligation to disclose their business outlook as before.\textsuperscript{23} In short, starting with this Standard, the
regulatory approach towards forward-looking statements was generally dichotomized: voluntary
for earnings projection and mandatory for business outlook. Though the Standard has been
revised for several times later, such a dichotomized philosophy has remained unchanged.

In summary, if we recall the vital role played by earnings projection in IPO selecting process and
mechanism of determining offering price, there would be no wonder that in regulating forward-
looking information, the Chinese regulator has spared much effort in making rules on earnings
projection, which can be demonstrated by the fact that the majority provisions just focused on
this issue. Under China’s securities offering mechanism, the regulatory authority enjoys wide
discretion in approving offering application. At the starting years of stock market, the authority
believed the earnings projection as a key indicator to distinguish ‘good’ applicants. Also in short
of sophisticated institutional investors who later actively participated in determining offering
price, the authority always made earnings projection as an indispensible component in reaching
the offering price. Though the 1997 Standard no longer requires the disclosure of this
information to be mandated, offering applicants still treated it pivotal because they had to use the
data to attract both regulator and investors. This over reliance on earnings projection resulted in
offering applicants’ stronger incentive to exaggerate this information so as to attain offering
qualification and bolster offering price, the situation of which was further worsened by the lack
of an investor protection regime.

\textsuperscript{22} Ibid
\textsuperscript{23} 1997 Standard No.1, sec. 20. (titled ‘Business Outlook’)}
III: Current Regulatory Framework Governing Forward-looking Information Disclosure in China

The current bewildering regulations over forward-looking information are scattered in an array of legal norms with different hierarchies from national laws, CSRC’s administrative rules to stock exchanges’ self-regulations. Forward-looking information in China context mainly refers to earning projections, business outlook, future trend embedded in management discussion and analysis (MD&A), and pre-announcement of performance before the formal release of periodic disclosure. As provided by the 1997 Standard, the regulatory approach is still dichotomized: disclosure of some information like earnings projection is voluntary; while others are still mandatorily demanded. This part not only systemizes these scattered regulatory norms, but analyzes their deficiencies with the aim to paving the way for a reform direction, a topic to be tackled in the next part.

1. Earnings Projection

Reliable earnings projection is arguably the most valuable forward-looking information in the eyes of investors, particularly when such projection is made by issuer itself enjoying the unmatchable information advantage, since what investors actually are buying is the tomorrow of issuer. As a continuance of voluntary approach towards earnings projection afforded by 1997 Standard No.1, the revised version (hereinafter ‘Standard No.1’) that is currently in effective allows the issuers having the ability to make reliable projection to make this statement in the prospectus. Article 85, somewhat ostensibly similar to ‘bespeaks caution’ enshrined in U.S regulations over forward-looking statements, mandates that disclosed earnings projection shall be stated ‘hand in hand’ with a cautious warning, which reads ‘The issuer has used best effort to make the earnings projection on the basis of most favorable underlying assumptions. But the

24 Standard No.1, art. 84.
uncertain nature of hypothesis based on which the earnings projection is made determines that the investors should be cautious when making investment decision on the reliance of the projection. Moreover, under article 86 which stipulates a quite detailed demand on how earnings projection shall be stated in the prospectus, issuers shall not only disclose the number of predicted earnings, but underlying assumptions on which the projection is made and other relevant background information that can facilitate issuer to evaluate the reliance of forecast more intelligently. These similar regulatory norms could also be identified in Standard No. 11 regulating listed companies’ seasoned public offering.

Like the auditing requirement in 1997 Standard No.1, the earnings projection, if disclosed, shall still be duly audited by a qualified accounting firm. The difficult in auditing forward-looking information lies in that the ‘future’ cannot be easily verified ex ante. In that regard, the Institute of Certified Public Accountants in China (CICPA) specifically enacted a practice guidance shedding light on how auditing of earnings projection should be carried out. Also notably, the issuers that have voluntarily disclosed earnings projection are subject to a ‘continuous disclosure and reflection’ duty. For example, article 33 of the Standard No.2 governing the contents and formats of listed company’s annual report demands that, if the actual performance of the company is 20% lower or 20% higher than that in the disclosed earnings projection, the company shall state the reasons for such deviation in the annual report. A similar requirement is also articulated in Standard No. 3 governing listed company’s semi-annual report, which mandates

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25 Standard No.1, art 85.
26 Standard No.1, art. 86.
27 Standard for Contents and Formats of Information Disclosure No.11, Public Offering by Listed Companies, art. 42,43,44. (CSRC, 2006)
28 Standard No.1, art.8.
29 Independent Auditing Practice Pronouncement No. 4—Examination of Profit Forecasts (CICPA, 1996)
the company to evaluate the disclosed projections in the contest of half-year’s actual performance and state the progress achieved in the way towards fulfilling projection. If the board, on the basis of this half-year’s performance, perceives that corporate may probably suffer a loss or a significant departure from profits gained last year at the end of this reporting year, then it is obligated to release an early warning to the market.

The requirement that a cautious statement to be accompanied with earnings projection arises from regulator’s concern that investors may put too much reliance on it. However, whether such a mandated cautious warning can fulfill its expected function is doubtful. Ostensibly, this warning is a transplant of ‘bespeaks caution’ doctrine enshrined in U.S regulations over forward-looking statement. But it seems that the regulator did not grasp the true rationale behind ‘bespeaks caution’ and just transplanted the rule’s ‘skin’ rather than ‘flesh’, since an ‘article 85 warning’ would definitely be treated as an ineffective ‘boilerplate warning’ under U.S law.

Apart from that, it is also nebulous whether the disclosure of this cautious statement amounts to a defense for issuer if ex post, investors allege issuer’s earnings projection is misleading or even fraudulent because of a large disparity between actual performance and forecast.

Institutively speaking, issuers’ incentive to disclose earnings projection shall not be mitigated just because the law no longer mandates its disclosure, since standing on the demand side, issuers need to resort to such information to make themselves stand out in the market so as to

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32 Standard No. 3, art.34.
33 See e.g., Huddleston v Herman & MacLean, 640 F. 2d 534, 543-44(5th Cir. 1981) (boilerplate warnings are insufficient to invoke ‘bespeaks caution’ and thus issuers won’t be able to attain ‘safe harbor’ protection regarding the disclosed soft information)
attract adequate capital supply. But the fact just went to the opposite side of this institutive thinking. Empirical studies document that the number of issuers who voluntarily disclose earnings projection in IPO prospectus has undergone an incremental decrease since the change of regulatory philosophy.\(^{34}\) One may naturally be tempted to jump to the assertion that this trend may illustrate that Chinese investors do not take too much consideration of earnings projection when making investment decisions, since otherwise, high-quality issuers always have a strong incentive to disclose so as to distinguish themselves from ‘bad apples’ and thus lower the cost of capital.

However, some more convincing explanations to this trend may be offered if we explore this phenomenon in a broad institutional picture of Chinese securities market. First is the lack of efficient ‘safe harbor’ regime which can mitigate issuer’s concern of increasing litigation risks.\(^{35}\) Though currently the Chinese issuers needn’t worry so much as their U.S counterparts due to the short of both a strong public and private enforcement regime, they nevertheless still run the risk of being obligated to apologize and explain, or even being investigated by the CSRC if certain \textit{ex post} deviation between projections and actual performance occurs.\(^{36}\) From the lens of issuers, apart from assuming the burden of apology and explanation, they would also suffer reputational damage which does have teeth in Chinese context. As two Columbia Law professors found, reputational sanctions may lead to abnormal stock price returns and banks also use such data for


\(^{35}\) The role of ‘safe harbor rule’ in encouraging voluntary disclosure of forward-looking information will be discussed in Part IV

\(^{36}\) Recall 1996 Notice requires the issuers to apologize and explain in CSRC’s designated news paper if actual profit is lower than the projection by 10-20%; moreover, CSRC will conduct an \textit{ex post} investigation if the deviant is at least more than 20%.
their purpose in deciding whether and how much loans can be extended to the issuers.37 Besides, more severe punishments may also be imposed if misconducts are unfortunately unrevealed by the CSRC during its investigation. Considering the unresolved question whether the issuer can resort to article 85’s boilerplate warning as a defense, thus understandably, issuers are very reluctant to voluntarily disclose earnings projection so as not to invite trouble.

Second, investors’ ‘ignorance’ of valuable earnings projections also arises from the large disparity between supply and demand of new securities. On the one hand, Chinese investors do have the money and enthusiasm to engage in capital market. While on the other, despite the fact that China is witnessing an incremental liberalization of its financial market, many investment channels are still not accessible to Chinese investors, particularly retail ones who can probably just invest in stock market.38 Considering the numbers of new public offering are tightly controlled by the regulatory body, the fact that demand (capital from enthusiastic investors) far outstripped supply (new shares distributed to public) led to Chinese IPOs to be a surefire path to get rich for anyone lucky enough to get onboard before a listing, with share prices often doubling on new shares’ debut.39 Thereby in the eyes of investors, what matters them most is whether they may be the lucky ones to attain some shares from the primary market rather than the issuer’s future manifested by earnings projections.40 While for new issuers, such a demand surplus

38 After the credit crunch, individuals still have very limited investment choices, making the Shanghai and Shenzhen stock market extremely attractive when they start rising. Similarly, in 2007 before the financial crisis, its main indices jumped more than 40% that year on top of the previous year’s meteoric 130% rise. ‘Nationwide Mad Bull Fever’. China Daily, June 11, 2007(quoted from Xiao Huang, Modernizing the Chinese Capital Market: Old Problems and New Legal Responses, 21 I.C.C.L.R. 28, 28(2010))
39 Simon Rabinovitch, Aborted IPO Marks Milestone for China, Financial Times, June 10, 2011, at 20
40 In an interview with Li kefei, head of China equity capital markets at UBS Securities conducted by Financial Times in June, 2011, Li asserted, 'When I was doing IPOs two years ago, investors were not asking as many
largely lessened their incentive to achieve a ‘signal effect’ through voluntary disclosure of earnings projections, because investors’ frenzy over new offerings largely mitigate issuers’ worry of popularity of their new offerings.

One may argue that though demand and supply analysis sounds reasonable, such an explanation is largely based on the assumption that investors are generally opportunistic and unsophisticated, who are only interested in making one-shot gain regardless of issuers’ intrinsic value as partially manifested by earnings projection. In essential, this argument challenges an overlook of the role played by sophisticated institutional investors, who should be more rational in fact of IPO frenzy. In fact, it happens to unearth another problem surrounding Chinese securities market: lack of matured institutional investors, who not only have the sophistication to analyze issuers’ forward-looking statements, but hold the leverage to demand issuers to provide such information (this assertion may also be extended to the fact of short of other market intermediaries like securities analysts, credit rating agencies). As one commentator asserts, though recent years have witnessed a rise of institutional investors’ activism, a host of legal barriers such as shareholding disclosure requirement, portfolio regulation, have largely deterred institutions from playing a more active role in Chinese capital market.

2. Outlook of Future Business Development

In contrast to voluntary disclosure of earnings projection, forward-looking information regarding the outlook of issuer’s future business development is rather mandatorily required. Taking issuer’s IPO prospectus as an example, outlooks of business development of the offering year

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questions. Now you can see a significant change. They do a lot of work and ask smart and tough questions.’ See. Rabinovitch, supra note 39

41 Qin, supra note 34, at 78

and following two years are mandated as a special section where the issuer shall disclose, inter alia, plans to enhance its competiveness, market, business and financing.\textsuperscript{43} Notably, besides the plan itself, issuers shall further state the predicted difficulties they will encounter in implementing the plan and preparations to overcome them so as to ensure the smooth progress towards fulfillment.\textsuperscript{44} Interestingly, issuers also need to explain the relationship between current business and future development as stated in business outlook.\textsuperscript{45} The rationale behind this may probably be regulator’s belief of an implied co-relationship between ‘overly ambitious business plan’ and ‘exaggerating statement’, that is, the more disparity there is between the current business and outlook, the more likely that such a statement is exaggerating which will mislead the investors.

In comparison with earnings projection, it is envisaged that fewer problems would occur around business outlook. Unlike the statement of earnings projection where the issuers usually directly list an estimated number, the value of business outlook is not that straightforward. The rough language such as ‘We plan to enlarge our market share in northern part of China’ does not make much sense and provide investors too much useful information to facilitate their decision making. Perhaps only those sophisticated investors who cherish a good knowledge of macroeconomic environment and familiarize industrial dynamics are able to conduct an ‘anatomy’ over this information and incorporate it into investment-making process.

\textsuperscript{43} Standard No.1, art.98.  
\textsuperscript{44} Standard No.1, art.99.  
\textsuperscript{45} Standard No.1, art.100.
Arguably, only sophisticated investors, who cherish good knowledge of macroeconomic environment and industrial dynamics, can conduct an ‘anatomy’ of this information and then incorporate it into investment decisions. Also, it is reasonably conceivable that being concerned of divulging business secrets in outlook, issuers would rather be quite conservative in making their plan public which further lessens the value of such information. Therefore, under the influence of these two factors, issuers would be less prone to exaggerate statement of its business outlook.

3. Management Discussion and Analysis (MD&A)
MD&A is intended to give the investor an opportunity to look at the company through the eyes of management by providing a both short and long-term analysis of the business of the company.\(^46\) The Chinese regulatory imposes an affirmative duty on the issuers to disclose certain forward-looking information like earnings capacity, shares’ liquidity, capital expenditure and financial situations in MD&A part embedded in both issuers’ public offering prospectuses and listed companies’ periodic disclosures.\(^47\)

Taking the MD&A part of an IPO prospectus as an example, the new issuer is required to largely focus on three main categories of forward-looking information, namely financial situation,

\(^{46}\) ‘Looking the company through the eyes of management’ is actually the rationale afforded by the U.S SEC in explaining its policy consideration of Item 303 of the Regulation S-K, the MD&A disclosure part in U.S securities regulation realm. It is submitted that this assertion may also be well applied into Chinese context to explain the purpose of mandatory disclose of certain forward-looking information in MD&A part. See. SEC Interpretation: Management’s Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures (SEC Release No. 33.6835)

\(^{47}\) Here, the ‘public offering prospectus’ refers to prospectus of new issuers’ initial public offering (IPO) and listed companies’ seasoned public offering. ‘Listed companies’ period disclosures’ refer to issuers’ annual report, semi-annual report and quarterly report. It is noted that in Standard No. 1 regulating IPO prospectus and Standard No.11 regulating seasoned offering prospectus, the forward-looking information discussed in this part is mandated to be disclosed under a part explicitly titled ‘Management Discussion and Analysis’. While in Standard 2, 3,13 regulating the disclosure of annual, semi-annual and quarterly report respectively, the same information is mandatorily required under the Part titled ‘Reports of the Board of Directors’ instead of ‘MD&A’. For a summary of these rules, see appendix table to this article.
earnings capacity and foreseeable capital expenditure in the near future. For the item of earning capacity which may raise investors’ most attention, the issuers shall disclose the sources of last three years’ profits and main trends or events that would have an impact on the continuity and stability of earning capacity. Besides the disclosure of these three main categories, the last article of MD&A regulation, functioning as a catch-all provision, obliges issuers to cautiously and objectively analyze any future trends affecting its financial situation and earning capacity. More particularly, the issuer needs to analyze the impact exerted by the following two elements: a. existing facts that already have had a material impact; b. existing new trends or changes that will have a material impact.

This catch-all provision needs some further exploration. As discussed above, if the issuer decides to voluntarily disclose earnings projection, it would be under an obligation not only to list an estimated number as future earnings, but underlying basis for such prediction. Understandably, issuers are likely to discuss information like future trends or events that may materially impact the forecasts as part of this underlying basis. Therefore conceptually speaking, there may occur some overlaps in disclosure of underlying basis accompanying the voluntarily disclosed earnings projection and mandatory information required by the catch-all provision in MD&A regulation. In light of the total different nature of these two disclosures, issuers may find it difficult to determine where the information about trends or events should be duly placed. One sensible distinction may lie in that, for the ‘trends or events’ in MD&A part, this mandatory disclosure is based on currently known new trends or changes that may have a material impact on issuer’s future financial situation or earnings capacity; while for the information of trends or events that

48 Standard No.1, part. 11. (titled ‘Management Discussion and Analysis’).
49 Standard No.1, art. 93(2), 94(2); Standard No.11, art. 48(2), 49(2).
50 Standard No.1, art. 97; Standard No.11, art. 52.
may likely be disclosed by the issuer in discussing underlying assumptions on which the earnings projection is made, it includes those factors, which though currently unknown, nevertheless could reasonably expected to occur in future and cause a material impact on issuers earnings projection.  

4. Pre-announcement of Issuer’s Performance

The practice that listed companies should make a pre-announcement of their performance before the formal release of periodic disclosures was introduced by the self-regulations of China’s two stock exchanges, located in Shanghai and Shenzhen respectively. Two notices issued by both exchanges regarding listed companies’ 2000 annual report work represents the institutionalization of this mechanism. The rules provided that if a listed company predicted that its actual performance would likely turn out to be a loss after the fiscal year of 2000 but before the release of 2000’s formal annual report, it shall then immediately make a pre-announcement of this likely loss. Based on feedbacks and lessons gained from this ‘pilot scheme’, one year later the two stock exchanges expanded the applicable scope of this pre-announcement rule to both estimated loss and gains. Meanwhile, this institution was also extended to semi-annual and quarterly reports.

51 As the article analyzes above, the current Chinese regulatory philosophy over forward-looking information is very similar to that of U.S where there is also some fuzzy about the distinction of the mandatorily required predictions and projections of Item 303 under Regulation S-K (MD&A part) and those optimally disclosed as the basis for predicting future earnings. The SEC attempted to separate the two with the following explanation: ‘Required disclosure is based on currently known trends, events and uncertainties that are reasonably expected to have material effects. In contrast, optimal forward-looking disclosure involves anticipating a future trend or event or anticipating a less predictable impact of a known event, fraud, or uncertainty’. See Concept Release on Management’s Discussion and Analysis (Securities Act Release No. 6711, 52 Fed. Reg. 13715, 13717) (Apr. 24, 1987). See also: Brian Neach, Item 303’s Role in Private Causes of Action Under the Federal Securities Law, 76 NOTRE DAME. L. REV.741, 750 (2001).


Moreover, both of the stock exchanges set a 50% year-on-year change as the threshold to trigger listed company’s obligation to make the pre-announcement. Therefore in a nutshell, before listed company’s real actual performance could be determined, if it predicts that its actual performance would turn out to be either (a). loss or (b). at least a 50% year-on-year increase or decrease of profits, then the listed company would be obligated to make a pre-announcement of this prediction before releasing the formal disclosure. Notably, a listed company was not prohibited from making such pre-announcement when the triggering threshold is not passed. That is to say, the pre-announcement rule is either mandatory or voluntary, depending on issuer’s prediction of loss or 50% change of profits.

Three main purposes are expected to be achieved by this mechanism. First, it may serve as an early warning to the market regarding issuers’ actual performance, so that fluctuations of the market prices may be lessened when the formal periodic disclosure is released. Second, given the significant impact of issuers’ periodic disclosures on stock price, some perpetrators may deliberately spread rumors about issuers’ performance before the formal release with the sole purpose to manipulating stock price. While for the issuer, after the rough statistics having been done but before having these data audited and incorporated into formal reports, it may tip undisclosed information pertinent to its performance to preferable investors, like large institutional shareholders as a consideration for their future ‘support’. Thereby the pre-announcement is expected to both clarify market rumors through issuer’s ‘own mouth’ and

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Ibid
mitigate information bias suffered by the majority of retail investors.\textsuperscript{55} Third, warning of issuer’s abnormal performance may also invite stricter scrutiny from the regulatory which may lead to a possibility of unearthing issuer’s internal misconduct at an early stage.\textsuperscript{56}

Though empirical studies demonstrated that this pre-announcement requirement has been complied well by most of the listed companies, they have also noticed that this mechanism has been manipulated by some companies as an easy means to artificially bolster short-term stock prices.\textsuperscript{57} Based on the argument that such pre-announcement is forward-looking in nature which cannot be fully verified at the moment of announcement, these companies would first declare quite attractive estimated profits in their pre-announcements, which immediately stimulate the stock price. But the data in later released periodic disclosures totally ‘change their face’, that is, the previous earnings projections are usually restated to a miserable loss, eventually leading to a dramatic plummet of share price.\textsuperscript{58} Understandably, there may exist some possibilities that companies need to adjust previous projections stated in pre-announcement since after all, the pre-announcement is usually made before all the data have been appropriately audited. However an entire adjustment from one spectrum (projected profits) to another (miserable loss), as happened

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\textsuperscript{56} Ibid
\textsuperscript{58} Taking ‘Luoyang Glass Company’ case as an illustration, it announced a earnings projection in its pre-announcement before formally releasing its annual report of 2007, stimulating its market price to increase by 7.76\% on the day of announcement. While in its formal 2007 annual report released one month later, it declared a RMB 73 million loss, totally opposite to the profits projections announced one month earlier. The market price plummeted from RMB 8.00 to 5.88 within three consecutive trading days. See. Chenli Liu: \textit{Reflections on the Change of Pre-announcement of Earnings Projection—Taking Luoyang Glass Company as an Example} (Yeji yugao bianlian de sikao—Yi Luoyang boli weili), 2 JOURNAL OF MONITORING OF FINANCE (Caizheng Jiandu). 79, (2010).
\end{flushleft}
to some Chinese listed companies, do indicate a high probability of market manipulation scheme, where investors are fooled by these companies easy as pie.

In reality, considering the difficulty in collecting persuasive evidence to prove market manipulation so to make suspected perpetrators subject to civil or criminal regime, the companies that restate their performance dramatically are more likely to receive ‘soft sanctions’ imposed by stock exchanges, like reputational sanctions or recording issuers’ misbehavior in a newly-set ‘good faith file’. These forms of sanctions, though ostensibly lenient, do arguably have own teeth. Taking ‘good-faith file’ as an example, its negative influence on the recorded issuers is two-fold: first, directors, supervisors would have their qualifications to hold their posts ‘restricted’; second, in China’s bureaucratic environment, the regulator still retains wide discretion, such as approving seasoned offering applications from listed companies, it is possible that, for companies having bad records, the probability of ‘impressing’ regulator and getting approval from it would largely be lower than those cherishing good records.

Despite of the teeth that ‘good-faith-file’ may have, the deficiency around it lies in its darkness, that is, it is currently not publicly accessible and could only be checked by ‘insider bodies’ like

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59 Guidance on Listed Companies’ Information Disclosure—Pre-announcement of Performance, art. 13. (Shenzhen Stock Exchange)
61 See. Establishing Uniform ‘Blacklist’, Innovating Regulation Approach (Legal Department of CSRC), available at: http://www.cs.com.cn/sylm/jsbd/201010/t20101007_2615695.html (last visited 30 May, 2011) Another aspect worth noting is that the CSRC has established a classified monitoring system, that is, classifying the regulated companies into A, B, C, D, E five different categories based on their records of good-faith files and other elements. For companies falling into A category (the most satisfying one), the CSRC may focus less and leave the companies to have their own internal compliance, such as exempting the submission of reports to CSRC for check. Therefore, the cost of compliance would be less for A category companies comparing with others falling into less satisfying categories.
CSRC, stock exchanges or China Securities Association. It suggests that the CSRC should rather make this blacklist open so that investors may gain first-hand resources to evaluate their potential investment targets, which would add another layer of system’s deterrent effect on making improper pre-announcement since investors would have less interest, or even lose confidence on a listed company whose name has been recorded on the blacklist for a number of times. Such a loss of confidence is arguably most fatal to a listed company since it may functionally amount to the fact of a gloomy future.

Furthermore, though these soft sanctions do have real impact on listed companies, considering the value that pre-announcement mechanism may bring to investors, it proposes that based on lessons and experiences gained from more than 10-year’s practice, the regulator may well incorporate this mechanism into its administrative regulatory norms, so that irresponsible listed companies are to be subject to more severe administrative sanctions which may arguably have a more profound impact on companies to take this requirement seriously.

5. Gatekeeper’s Role in Forward-looking Information—Auditors’ Duty and Liability

The responsibility of gatekeeper in corporate information disclosure has initiated global attention particularly after the finding of their role played in the collapse of Enron and WorldCom. The Chinese regulators also have put much expectation on gatekeepers, especially auditors in guaranteeing the quality of disclosed information. For example, if the issuer decides to voluntarily disclose earnings projections in offering prospectus, then such information shall be

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62 Ibid
63 In fact, the CSRS has also realized the non-publicly-accessible problem of the Good-Faith Files and it intends to make the list open to all market participants. See The CSRC Considering Opening Good-Faith Files, CAIJING MAGAZINE, Jan, 2011, available at: http://www.caijing.com.cn/2011-01-10/110615276.html (last visited 30 May, 2011)
64 For a thought-provoking discussion of gatekeeper’s role in corporate governance, see. JOHN C. COFFEE, GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006)
duly audited by a qualified accounting firm. As a corresponding response to this expected function played by auditors, the Chinese Institute of CPA (Certified Public Accountants) also enacted detailed guidance on procedure and substantive ways of auditing earnings projection, which makes it clear that the main responsibility for auditors is to audit the assumptions and accounting policies based on which the issuer make its earnings projection.

Meanwhile, with the purpose to converting the declaratory provisions that the auditors or accounting firms shall assume liability for untrue audited disclosures as provided in Securities Law and Law on CPA into practice, the Supreme People’s Court has also issued a judicial interpretation providing detailed rules on various issues of civil actions arising from inappropriate auditing. Three features are worth of noting here. First, it explicitly recognizes the legal effect of the practicing standard on auditing earnings projection made by Chinese Institute of CPA, which implies that auditor’s failure to comply with this industry-recognized self-regulation will invoke civil liability. Second, the judicial interpretation defines ‘interested party’ as one who has suffered damages in securities transactions relying reasonably on the disclosure that was improperly audited. The significance of this provision is that it actually

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65 See e.g., Standard No.1, art. 8.
66 Independent Auditing Practice Announcement No.4, art.5.
67 Securities Law, art.173. (stating that securities intermediaries shall bear joint and several liability with the issuers in case of false or misleading statements and material omissions, unless the intermediaries can prove its faultlessness)
68 Law on Certified Public Accountants, art. 42. (stating that accounting firms shall assume civil liability to clients or interests parties for violating laws or regulations) It is noted that though there is a specific law called ‘PRC Auditing Law’, the coverage of this law is only limited to governmental auditing instead of auditing for private sectors.
69 See. Guanyu Shenni Kuaijishi Shiwsuo zai Shenji Yewu Huoding zhong Minshi Qinquan Peichang Anjian de Ruogan Guiding [Several Rules on the Adjudication of Cases Involving Civil Tort Liability Incurred by Accounting Firms in the Course of Auditing Business] (promulgated by the Supreme People’s Court on June.11, 2007 and effective on June 15, 2007) (hereinafter ‘Several Rules on Auditing Liability’)
70 Several Rules on Auditing Liability, art. 2.
71 Several Rules on Auditing Liability, art.2.
explicitly bestows investors a private cause of action against auditors for compensation.\textsuperscript{72} Third, the rebuttable presumption that auditors are at fault unless they can provide evidence otherwise is rather investor friendly, \textsuperscript{73} which can lessen the evidential hurdle for disgruntled investors and in turn may enhance auditor’s sense of responsibility towards their work.

Intriguingly, if comparing this interpretation on auditor’s liability with the one targeting at false statement by listed companies issued by the Supreme People’s Court in 2003, we may find that the rule-maker seems to be more ready to impose civil liability on auditors than on listed companies. Under 2003’s interpretation, aggrieved investors have to surmount a procedural hurdle before they can take the company to the court for civil compensation, that is, they have to wait for either an administrative or criminal punishment made against the listed companies.\textsuperscript{74} While for cases against auditors for compensation, no such ‘roadblock’ is set before the investors who may directly bring the auditors to the court.

It is admitted that the purpose of these provisions is to encourage auditors to be more diligent and accountable towards investors, however it is always a cliché that there exists a talismanic disparity between law-on-books and law-in-practice in China. Prof. Clarke’s empirical study of cases against accounting firms again disappointedly illustrates that institutions of liability against

\textsuperscript{72} Several Rules on Auditing Liability, art. 1. (providing that interested parties may institute a civil compensation case against auditors for damage suffered due to the false audited reports.) For a detailed discussion of this judicial interpretation from both a theoretical and practical perspective, see. UNDERSTANDING AND APPLICATION OF ‘SEVERAL RULES INVOLVING ACCOUNTING FIRM’S AUDITING BUSINESS: DOCTRINES, INTERPRETATIONS, RATIONALES AND CASES, 71 (2007 Second Division of Court of Civil Cases of the Supreme People’s Court)

\textsuperscript{73} Several Rules on Auditing Liability, art. 4.

accounting firms have hardly been deployed in practice, leaving a big question mark on whether seemingly investors-friendly provisions can really bolster gatekeepers’ accountability.


The deficiencies of regulations over forward-looking statements in China are threefold: first, the bewildering regulations are scattered in a number of legal documents without a systematic framework; second, the current rules do not provide a ‘safe harbor’ for issuers or listed companies, which has largely contributed to the decreasing number of voluntary disclosure of earnings projections since 2001 when the regulatory philosophy changed; third, though the Supreme Court’s interpretation regarding investors’ compensation arising from false statement has been adopted for more than 8 years, investors still have to face many difficulties on their way in seeking justice.

This part, first by drawing experiences gained from the evolution of U.S regulations over forward-looking statements, charts a practical path to build a Chinese-tailored safe harbor scheme which can balance the competing interests involved and fit the development stage of Chinese securities market. Meanwhile, this part also suggests the Chinese regulatory body shall issue a specific interpretative release specifically tackling this issue, which may, for example, provide some illustrations and comments on what is a meaningful cautionary statement to invoke defensive protection provided by safe harbor. By doing that, investors may also be able to better

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75 Prof. Donald Clarke only found seven cases involving civil remedies against accounting firms in the last ten years, all of which were instituted by creditors. Also in four years from 2004 to 2007, the CSRC issued a total of 160 administrative punishments targeting all kinds of market misconducts, among which accountants were fined four times in 2004, three times in 2005, once in 2006 and three times in 2007. Besides, there were only three criminal cases involving accounting firm’s misconduct. See Clarke, supra note 60, at 164-167.
evaluate the effectiveness of disclosure. Furthermore, realizing that *ex ante* safe harbor won’t have much impact on issuers or listed companies’ behavior in disclosing forward-looking information if *ex post* liability rules are not able to achieve the punishment and deterrent effect, this part also sheds some light on how the problem of investors’ compensation arising from improper forward-looking statements may be incrementally resolved.

1. A Brief Overview of Evolution of U.S Securities Regulations on Forward-looking Information Disclosure

It is interesting to note that institutional evolutions of regulatory philosophy over forward-looking information in U.S and China have just undergone an opposite direction. Unlike the Chinese regulator who mandated the companies to make earning projection at the very beginning of building its stock market, the U.S SEC used to perceive that such information was inherently unreliable and was deeply concerned that unsophisticated investors might be overreached by companies willing to make unfounded predictions of success and value.\(^6\) The SEC also realized that conducting an examination of the reliability of such information on a case by case basis prior to disclosure amounted to an ‘impossible mission’ due to its limited resources and inherent uncertain nature of forward-looking information.\(^7\) Thereby before 1972, projections were generally prohibited from being disclosed out of SEC’s intention to prevent unsophisticated investors from undue credence to such information.\(^8\) Such a paternalistic approach was encountered with serve critiques, among which Prof. Homer Kripke wrote the most seminal law


\(^8\)In a SEC’s 1977 report by the Advisory Committee on Corporate Disclosure (widely-known as ‘Sommer Report’), three reasons for Commission’s prohibitory attitude towards forward-looking information disclosure were provided. First, it is necessary to prevent undue investor reliance or managerial manipulation. Second, projections were sometimes characterized as not involving ‘facts’ and as inherently unreliable. Third, investors were characterized as being just as competent as managers to make projections. See Joel Seligman, *The SEC’s Unfinished Soft Information Revolution*, 63 FORDHAM. L.REV. 1953, 1955 (1994).
review article. After a thorough reflection of its previous prohibitory attitude, the SEC openly expressed its concern that all investors might not have equal access of projections with some gaining an improper information advantage, which thus set a tune to allow voluntary disclosure of forward-looking information.

Predictions of future events stand on a different footing from disclosure of factual information, the former of which may always be proven to be wrong in hindsight. Realizing this fact, the regulator created a new innovative tool to its regulatory ‘arsenal’, that is, ‘safe harbor’ mechanism, the purpose of which is to encourage the disclosure of projections by providing issuers with some certainty that they will not be sued successfully just on the allegation that projections are deviant from actual performance. The SEC adopted its ‘safe harbor’ rules under the 1933 Securities Act and 1934 Securities Exchange Act to the effect that a forward-looking statement wouldn’t be treated as fraudulent unless the plaintiff investor is able to show either a lack of reasonable basis or lack of good faith. Unfortunately, the expected result that increasing numbers of companies would ready to voluntarily disclose projections under the ‘protective shelter’ afforded by this safe harbor rule did not occur. One reason behind may be that unlike its name suggests, the safe harbor did not provide too much protection to issuers, since they could not apply to the court for dismissing plaintiff’s case at early stage who still

79 Homer Kripke, supra note 4.
80 SEC New Digest (Issue No. 73-23, released at February 2, 1973) (The Commission believed that it would be in the public interest and would assist in the protection of investors to change its policies [towards forward-looking information disclosure])
81 See. e.g., G.R. Rep No. 104-369, at 44 (The safe harbor seeks to provide certainty that forward-looking statements will not be actionable by private parties under certain circumstances). Also see, Jennifer O’Hare, supra note 10, at 639.
82 Rule 175 under 1933 Securities Act; Rule 3b-6 under 1934 Securities Exchange Act; adopted by Sec. Act Rel. 6084, 17 SEC Dock. 1048 (1979). This SEC-made ‘safe harbor’ is available to companies subject to the reporting requirements of the 1934 Act that have filed their most recent Form 10-K annual report or to non-reporting companies for statements made in a registration statement under the 1933 Act.
needed to spend quite a lot resources in debating nebulous concepts like ‘reasonable basis’ or ‘good faith’.  

Being much concerned of the increasing numbers of private class actions arising from forward-looking statements on one hand and low utility of SEC’s safe harbor rule on the other, the Congress promulgated the 1995 Private Securities Litigation Reform Act (PSLRA), among which the most hotly contested provision was just the creation of a new statutory safe harbor for forward-looking statements. Eventually, this reform targeting at private actions resulted in a new two-prong statutory safe harbor:

The first prong: if the issuer is able to persuade the court either of the following: a). the forward-looking disclosures were accompanied with a ‘meaningful cautionary statements’ identifying important factors that could cause actual results to differ materially from those shown in the forward-looking statements; or b). the forward-looking statements were immaterial themselves;

The second prong: even if the defendant issuer can prove neither the adequate meaningfulness of cautionary language nor immateriality of projections, it may still have a large chance of being insulated from liability, because the plaintiff, in order to deprive defendant’s safe harbor protection, have to prove defendant’s ‘actual knowledge’ of misleading or fraud nature of the forward-looking statements, which is a higher culpability standard than

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83 EDWARD F. GREENE, U.S REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVE MARKETS, 15-29 (9th ed., 2008) (Despite the Rule 175 and 3b-6, forward-looking statements rarely are included in registration statements because of their inherent uncertainty and fears of litigation and liability)
84 LOSS& SELIGMAN, supra note 1, at 161.
‘recklessness’ or ‘negligence’ that is embedded in section 10(b) of the 1933 Securities Exchange Act. ⑧⑤

Notably, the first prong ‘meaningful cautionary statements’ could be understood as a codification of ‘bespeaks caution’ doctrine, a judicially-created doctrine under which if future forecasts, projections and expectations are accompanied with adequate cautionary language, then those forward-looking statements are not actionable as securities fraud.⑧⑥ Now this doctrine has been widely adopted by U.S issuers and become a standard feature of issuers’ periodic reports and other communications in which they disseminate such forward-looking information as earnings estimates and earnings per share, growth in demand for their products, cash flow and the like. ⑧⑦

2. A Critical Evaluation of U.S rules and Implications for China’s Safe Harbor Rule

2.1. ‘Material Risk Factors’ embedded in a ‘meaningful cautionary statement’
A meaningful cautionary statement includes the risk factors that may potentially cause actual performance to differ materially from the previously stated projections. It has been very clear that boilerplate warnings could never shield issuers from liability.⑧⑧ The key issue of the first statutory prong and also one of the most contested issues in the process of enacting PSLRA is

⑧⑤ LOSS & SELIGMAN, supra note 1, at 164.
⑧⑥ In re Donald J. Trump Casiion Sec. Litig. 793 F. Supp. 543, 549 (D.N.J.1992), aff’d, 7. F. 3d 357 (3d Cir. 1993); It is documented that ‘bespeaks caution’ was first developed by judiciary in Polin v Conductron Corp., 552 F. 2d 797 (8th Cir.) cert. denied, 434 U.S. 857 (1977) [The court found that the cautionary terms ‘bespeak caution’ in outlook and fall far short of the assurances required for a finding of falsity and fraud, because such soft-information recognized the unpredictable influences of complex variables in a fast-changing field’] But it is admitted that the judicially created ‘bespeaks caution’ is broader than the first prong of this statutory safe harbor while the statutory safe harbor is more protective within its domain. See. Note, When Does a Securities Disclosure Truly ‘Bespeak’ Caution? 20. U. DAYTON. L. Rev. 467, 475 (1995).
⑧⑧ See. e.g. In re Worlds of Wonder Securities Litigation, 35 (F. 3d) (adopting the district court’s holding that ‘bespeaks’ caution doctrine applies only to precise cautionary language which directly addresses itself to further projections, estimates or forecasts)
what this ‘meaningful cautionary statement’ actually requires. In another word, to what extent the issuer-tailored risk factors should be disclosed in the cautionary statement. Considering the ever-changing feature of business reality, the first quick response to this question may be that a meaningful cautionary statement shall not be required to include the exact risk factor that ultimately causes the deviation, since otherwise such a burdensome demand on issuer would rather make the rule counterproductive to Congress’s very purpose of creating a new statutory safe harbor, that is, encouraging issuers’ voluntary disclosure of projections. 89 If all risk factors are not needed, two alternative possibilities exist: one is requiring the issuer to disclose some important risk factors and the other is mandating it to disclose those risk factors it considers most significant. The former seems to become the mainstream view whose justification may be found even in legislative history documents. For example, the Conference Report only spells out the requirement that issuer shall identify important risk factors rather than all of them. 90

The problem for this approach is that the first prong of statutory safe harbor would even protect an issuer, who did not believe the projection it has disclosed because it has been aware of some particular important risks, but failed to state them in the cautionary statement. 91 The logic supporting this conclusion runs like this: the issuer may have the knowledge of a number of important risk factors and it may further know that some specific risks among them are most

80 The Conference Report provides that:

[the Conference Committee expects that the cautionary statements identify important factors that could cause results to differ materially—but not all factors. 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. The Conference Committee specifies that the cautionary statements identify ‘important’ factors to provide guidance to issuers and not to provide an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made. H.R. REP. No 104-369, at 44 (1995).
91 Jennifer O’Hare, supra note 10, at 665.
likely to cause the immaterialization of projection. As long as the issuer picks up some risk factors to be stated in the cautionary statement, even though it fails to disclose those specific risks, it can still be entitled to the projection afforded by the first prong of safe harbor because the issuer has duly disclosed some risk factors, which is just the requirement for a meaningful cautionary statement in the perception of mainstream idea. One demerit of this approach is that it is counterintuitive to grant protection to those who deliberately hide important facts and thus mislead investors. As Prof. Loss and Seligman asserted, ‘A cautionary statement found in risk factor or disclaimer should be given no weight if the defendant were aware or should have been aware of a prospective negative material fact and chose not to disclose it. In other words, the bespeaks caution doctrine should not be a device by which defendants can obscure or misrepresent prospective bad news.’ 92 Besides, this approach would make it difficult for investors to bring anti-fraud litigation against the issuer, even if the issuer’s disclosure has actually misled investors as to the riskiness of the forward-looking statements. 93

Another fallacy of this practice is that for issuers engaged in same or similar industries, it is likely that they will face some common risks that may cause a material impact on the materialization of projections. If the issuer is only required to disclose some important risk factors rather than those it perceives most significant evaluated on the basis of its own situation, then it is expected to observe a convergence of issuers’ cautionary statement among those engaged in same or similar business, thus reducing the ‘cautionary statement’ to another kind of boilerplate. 94 No wonder the former SEC Chairman Arthur Levitt criticized this low threshold of

92 LOUIS LOSS & JOEL SELIGMAN, supra note 1, at 2079.
93 Jennifer O’Hare, supra note 10, at 665.
94 As Prof. John Coffee commented, ‘Simply put the core problem is that the [Reform] Act’s safe harbor, as finally drafted, does not require the issuer to identify the substantive factors known to it that are most likely to cause actual
a ‘meaningful caution’ after its one-year implementation, ‘Rather than taking advantage of the new safe harbor to communicate forecasts more clearly, companies are using even more boilerplate in the form of cautionary language. It appears that the legal requirements of the safe harbor are being ‘over-lawyered’.95

In order to avoid this risk of ‘selective disclosure’ that may arise under U.S statutory safe harbor, it suggests that for the ‘bespeaks caution’ doctrine embedded in Chinese safe harbor rule shall rather require the issuer to disclose all substantive factors potentially having a material impact on the realization of projections that it was aware or should have been aware. In another word, if the plaintiff can prove that the issuer has failed to disclose some significant risk factors that it has actual knowledge or should have known in the cautionary statement, then this statement cannot be treated as meaningful. This proposed approach may probably achieve two purposes. First, if the issuer has disclosed all substantive risks it knows or should have known, the problem of information asymmetry will be mitigated and investors can more intelligently evaluate the projections. Next, disclosing all material risk factors the issuer knows or should have known could be deemed as a proxy of its ‘good faith’, an indispensible component in the proposed Chinese safe harbor rule.96

2.2. ‘Actual Knowledge Prong’ of the Statutory Safe Harbor
Another most hotly debated issue that has even led to President Clinton’s veto of the PSLAR bill is the relationship between first ‘bespeaks caution’ prong and second prong of ‘actual

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96 ‘Good faith’ component will be discussed in the next subsection.
knowledge’ under its statutory safe harbor: whether the ‘meaningful cautionary statements’ may constitute an independent safe harbor without the necessity of further considering the issuer’s state of mind at the time of disclosure. \(^97\) Ostensibly, the statutory language ‘or’ connecting these two prongs indicates Congress’s positive response to this question. That is, as long as either of the prong is satisfied, the issuer would be entitled to the protection afforded by safe harbor. As the Conference Report has explicitly stated explicitly, ‘Courts should not examine the state of mind of the person making the statement (emphasis added).’ \(^98\) What the courts usually do here is that once they have decided the effectiveness of cautionary statement, they will allow defendant company’s motion to dismiss or directly end the case with a summary judgment while ignoring plaintiffs’ allegation or even proof of defendant’s actual knowledge that the projection was incorrect at the moment of disclosure. \(^99\) In another word, the forward-looking statements surrounded by ‘meaningful cautionary statements’ will be insulated from challenge even if it is a knowingly false statement. \(^100\) The consequence of this approach towards the relationship between two prongs leads the statutory safe harbor to be reduced to become a ‘license to lie’. \(^101\)

\(^{97}\) 141 CONG. REC. 37, 797, 37, 797-98. Although President Clinton vetoed the bill, the veto was later overridden by the Congress by a vote of 319 to 100. But the promulgated law still invited strong critique from some of the members of the Congress. For example, Senator Sarbanes, after whose the name the later Sarbanes-Oxley Act was named, attacked the independence of first prong under statutory safe harbor:

‘Projections by corporate insiders will be protected, even though they may be unreasonable, misleading, and fraudulent, if accompanied by boilerplate cautionary language’. 141 CONG. REC, 38, 196, 38, 198.

Also see. Allan Horwich, supra note 10, at 536-537.


\(^{99}\) Indeed, this approach is currently upheld by most of the courts, even though some courts do assert that ‘actual knowledge of falsity’ would impact the issuer’s resort to ‘meaningful cautionary statement’ prong. E.g., Harris v Ivax Corp. 182 F. 3d 199, 803 (11\(^{th}\) Cir. 1999) (If a statement is accompanied by ‘meaningful cautionary language, the defendants’ state of mind is irrelevant’); No 84 Employer-Teamster Joint Council Pension Trust Fund v America West Holding Corp. 320 F. 3d 920, 937 (9\(^{th}\) Cir. 2003) (‘a strong inference of actual knowledge will except purportedly forward-looking statements from the safe harbor rule altogether’). For an excellent summary of cases illustrating courts’ different attitudes toward the relationship between ‘meaningful cautionary statement’ and ‘actual knowledge’, see. Allan Horwich, supra note 10.

\(^{100}\) J. ROBERT BROWN, THE REGULATION OF CORPORATE DISCLOSURE 6A-24( 3\(^{rd}\) ed, 2003)

\(^{101}\) Carl W. Schneider & Jay A. Dubow, Forward-Looking Information—Navigating in the Safe Harbor, 51 BUS.LAW.1071, 1087(1996). Also see Jennifer O’Hare, supra note 10, at 621. (So long as the disclosed soft
As Senator Sarbanes forcefully argued, ‘For the first time, fraudulent statements will receive protection under the federal securities law.’

In stark contrast, the previous SEC-made safe harbor rule does articulate that safe harbor could not be invoked if the plaintiff may prove that the defendant made the projections either a. without reasonable basis; or b. not out of good faith. This rule actually indicates the necessity of ‘state of mind’, since if the issuer disclosed a knowingly false projection, obviously it cannot meet ‘good faith’ requirement. The rationale for Congress’s no longer demand of issuer’s state of mind may be understood in light of the policy background in promulgating the PSLRA. Indeed, this new statutory safe harbor enshrined in the Act was created out of Congress’s concern of increased frequency of private litigations involved forward-looking statements during the 1980s and the early 1990s. If the element of ‘good faith’, acting as a proxy of issuer’s state of mind was still required as in SEC’s own safe harbor rule, it would make more difficult for the court to dismiss frivolous lawsuits at an early state of the litigation which was to continue endlessly with both parties’ arguing on the nebulous item of ‘good faith’. This result will just undo the legislative efforts in enacting the PSLRA.

While for Chinese safe harbor regime, unlike the current practice in U.S where an adequate cautionary statement can offer insulation from liability, there should still be a good faith requirement imposed on the defendant, who is not entitled to safe harbor protection if the plaintiff can prove that the defendant had actual knowledge or should have known the falsity of

\[\text{information contains 'meaningful cautionary statements', the statutory safe harbor would protect the issuer from claims that it violated the anti-fraud provisions, even though the issuer lied when it made the projections).}\]

\[102\] CONG. REC. S17, 938(daily ed. Dec.5, 1995)
\[103\] LOSS & SELIGMAN, supra note 1, at 161.
\[104\] Langevoort, supra note 10, at 488; Jennifer O’Hare, supra note 10, at 656.
its disclosed forward-looking statement. A number of reasons may support this proposition. First of all, the rationale for creating two different legal approaches towards forward-looking statements and factual information disclosure, namely adopting a more lenient philosophy towards the former by providing a safe harbor mechanism, lies in the realization of the intrinsically indeterminable nature of projections. The safe harbor rule is thus a response to mitigate liability arising from uncertainty of projections. Hence, it may be argued that the essential purpose of a safe harbor has nothing to do with issuers’ fraudulent disclosure and there would be no sound justification for extending its coverage to knowingly false statement. Second, given the fact of China’s fletching stock market where such market intermediaries as securities analysts that may constrain issuer’s misconduct, the danger that safe harbor may be reduced to a ‘license to lie’ may be worsened. Third, the U. S Congress’s reluctant to let court explore defendant’s subjective mind is actually an endeavor to mitigate the dark side of U.S’s idiosyncratic private securities litigation. The Congress felt anxious that the debate of ‘state of mind’ in courtroom will lead the litigation process into a stagnation with both parties debating this subjective issue, which will make the core purpose of enacting PSLRA futile. However in China, the regulator probably needn’t worry so much of the vexatious litigations due to the short of a serial of institutions like contingency fee and class action mechanism, which have arguably led to the popularity or even abuse of the private securities litigations. Thereby, the rationale for not exploring issuer’s state of mind in U.S is largely weakened in Chinese context.

Alternatively, issuer’s disclosure of a knowingly false projection may also be understood as a failure to meet the requirement of ‘meaningful cautionary statement’. As some U.S cases suggest, the accompanying cautionary language could only be meaningful if the issuer either states the
belief that it is false or misleading or, at the very least, clearly articulates the reasons why it is false or misleading. That is to say, a knowingly unreasonable projection would be insulated from liability only if the issuer disclosed its unreasonableness.

2. Extending the Safe Harbor Application to Statements Relating to IPO

Another noticeable aspect of U.S statutory safe harbor is its applicable scope. Section 27A of the 1933 Securities Act explicitly prevents several disclosures from the protective shelter afforded by the safe harbor such as statements made in connection with IPO or a tender offers. Considering one focus of this article is on forward-looking information embedded in public offering prospectus, then the question ‘why and whether safe harbor is unavailable for offering prospectus in U.S’ may arise. One response may be Congress’s concern that there is more risk for the new issuers to improperly ‘take advantage’ of the safe harbor mechanism to disclose overly optimistic or even fraudulent projections, while for already-listed companies who have entered the market long ago, they would be more self-constrained in disclosing exaggerating projections, since otherwise these companies would run the risk of being abandoned by the market if their disclosed attractive projections are always unable to be materialized.

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105 See e.g., SeeBeyond Technologies Corp. Securities Litigation, 266 F. 2d 1150 (C.D. Cal. 2003) U.S SEC also suggested that a safe-harbor-protected forward-looking statements should contain at least three implicit factual assertions, i). that the statement is genuinely believed; ii).that there is a reasonable basis for that belief; (iii). that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. Brief for Securities and Exchange Commission as Amicus Curiae, Slayton v Am. Express Co. No. 08-5442-cv (2d Cir Jan. 21, 2010), at 11-12. Also see. BROWN, supra note 100, at 6A-25.

106 BROWN, supra note 100, at 6A-26.

107 A tricky point of application of safe harbor in IPO situations is that reading Section 27A of 1933 Securities Act in the whole context of U.S securities regulation regime, it means that the statutory safe harbor afforded by PSLRA is only available to a company that is already filing reports as a publicly-held company and has previously made a registered public offering. That is, for companies a).who is totally new to the market because who has not filed reports with the SEC and who has not made a registered public offering before and b). who is not totally new to the market because it has been filing reports with the SEC but who has not made a registered public offering before; are not entitled to the protective shelter afforded by the statutory safe harbor with statements in connection with IPO. It may be reasonable for Congress to concern that those little known companies (i.e. category (a) company) to use safe harbor recklessly, but there seems no sound justification for SEC to exclude safe harbor from those companies who
regard, the Congress probably believed that fewer problems would occur if it bestowed safe harbor protection to listed companies rather than to new issuers.

However, such a perception, though sounds reasonable at first blush, cannot firmly stand. First, the assumption that new issuers are new to the market and thus have more incentive to attract investors via exaggerating projections ignores the fact that quite a number of new issuers have already been quite popular even before an IPO, thereby it is improper to correlate new issuers with danger to exaggerating statements. Second, excluding new issuers from resorting to safe harbor does not necessarily benefit investors. Information asymmetry is particularly demonstrable for IPO issuers who are new to the market (except those who have already been well-known before IPO, like Ford), and investors do need forward-looking information to make intelligent decisions. Considering the disclosure of some projections is voluntary in nature, excluding safe harbor from IPO prospectus would make new issuers more reluctant to disclose projections and thus deepens information asymmetry at this stage. There is no wonder that in reality, managerial disclosure of forward-looking information are seldom observed in the IPO in the U.S, and most frequently quoted reason for that is U.S’s highly litigious environment due to the lack of safe harbor. This phenomenon seems to be inconsistent with our conventional

have already been under a reporting duty, particularly because in such situations the open market price for the securities is likely de facto to determine the public offering price. See. Allan Horwich, Section 11 of the Securities Act: The Cornerstone Needs Some Tuckpointing, 58 BUS.LAW, 1, 35 (2001).(commenting that the Congress actually throwing the baby out with the bath water by depriving Exchange Act reporting companies of the protection of the safe harbor when they made their first public offering)

108 I thank Prof. Allan Horwich for this point. For example, like Ford Company, it has already been one of the largest companies in the U.S even before its IPO. We may also consider examples like Facebook which is still a closely-held company currently.


110 Ibid. Though IPO-issuers cannot avail themselves of statutory safe harbor, Rule 175 of the 1933 Securities Act still provides those issuers with a SEC-made safe harbor. The most significant difference between Rule 175 and statutory safe harbor lies in the discovery process in litigation, which arguably is the most ‘headache’ concern for the issuers. If the defendant’s case is based on statutory safe harbor, then as long as a meaningful bespeaks cautions
wisdom that albeit short of safe harbor protection, new issuers with good quality would tend to voluntarily disclose forward-looking information to ‘separate wheat from chaff. Perhaps these new issuers have reached an implied consensus that the benefits gained from voluntary disclosure are outweighed by the risks of being exposed to increasing litigation under a regulatory environment where safe harbor is not available. In fact, the SEC has realized the unsoundness of exclusion safe harbor from IPO, In its 2005’s reform on registration, communications and offering process, though the law was not immediately revised to extend safe harbor to IPO statements, the SEC nevertheless did seek public comments on proposals of such an extension, which may have some implication for the direction of future reform.\textsuperscript{111}

It is submitted that IPO cases are possibly the context best served by inclusion of forward-looking statements, since the most relevant information to investors that a company has at this stage is most likely forward-looking.\textsuperscript{112} Also as discussed above, one significant reason that has attributed to the decrease in numbers of issuers who voluntarily disclose projections in China is

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is accompanied with the forward-looking information, its application for summary judgment will be protected from discovery. As the Statement of Managers explicitly stated that ‘[t]he Conference Committee specified that the cautionary statements identify ‘important’ factors to provide guidance to issuers and not to provide an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made (emphasize added)’See H.R. REP. NO 104-369, at 44(Statement of Managers—The Private Securities Litigation Reform Act of 1995) While on the contrary, if it is based on Rule 175 (SEC-made safe harbor rule), the court still needs to have a close scrutiny of ‘good faith’ and ‘reasonable basis’, which means that the plaintiffs will be allowed to conduct a discovery of all surrounding environments of issuer’s making of forward-looking information. In summary, Rule 175 safe harbor’s protection is far less effective than the statutory one. Therefore it is within reasonable contemplation that IPO-issuers are not willing to voluntarily disclose forward-looking information if they could only be protected by Rule 175 but not the statutory safe harbor embedded in Section 27A of the 1933 Securities Act. Also see: Allan Horwich, \textit{supra} note 107, at 35-36.

\textsuperscript{111} SEC Release No. 3-8501. In this release, the SEC invited public comment on the following four questions relating to possible adoption of statutory safe harbor rule in IPO statements: 1. In IPO by non-reporting issuers, whether SEC should consider using its authority to propose a safe harbor for projections and forward-looking information that is similar to Section 27A of the 1933 Securities Act? 2. What kinds of conditions should be imposed on such a safe harbor? 3. As a condition for this safe harbor or one for IPO, should SEC require the issuer to file projections or other forward-looking information as part of the registration statement? 4. Would a liability safe harbor for IPO cause issuers to provide more projections publicly? Would there be concerns about the quality of these projections in light of the safe harbor?

the unavailability of safe harbor protection. In this regard, it is envisioned that Chinese safe harbor could well be applied by IPO issuers, since investors would be best served by encouraging such statements in a company’s first registration statement. Though currently investors seems to pay little attention on whether the issuers have voluntarily disclosed forward-looking information, since new shares can always be easily sold out due to the imbalance between demand and supply. Nevertheless, such frenzy of new IPO will likely to incrementally cool down in the near future with China’s continuous reform of IPO mechanism and increasing investment products for Chinese investors.

2.4. A Summary of the Chinese Safe Harbor

In summary, the proposed Chinese safe harbor is more similar to SEC-made safe harbor rule instead of the statutory one created by the PSLRA. The issuers or listed companies disclosing forward-looking information in prospectus or periodic disclosures shall be insulated from liability if either the disclosed projections are immaterial in nature or the following two steps could be satisfied:

1. **First step**: If an effective cautionary statement, including the underlying assumptions for forecasts and predicted risk factors, is accompanied with the forward-looking disclosure, then the issuer may establish a strong prima facie case to invoke the protection afforded by the safe harbor. Two points should be kept in mind, first, a boilerplate cautionary statement won’t be enough; second, the threshold for ‘predicted risk factors’ should be issuer-specific risks that the issuer actually knows or should have known that may have the impact that cause projections materially differ from actual performance.

113 Allan Horwich, *supra* note 107, at 35.
2. **Second step:** After the issue has established a prima facie case, the burden of proof would be shifted to plaintiff investors, who may still challenge that the issuer didn’t make the forward-looking statements in good faith. For example, if the investor can prove that the issuer fails to disclose a particular risk factor it knows or should have known which may contribute to the immaterialization of projections, then this can be both a proof that the cautionary statement is not meaningful and an indicator that the issuers did not make the statement in good faith.

3. **CSRC’s Specific Guidance of Forward-looking Information Disclosure**
   As pointed out at the beginning of Part II, the current Chinese regulations over forward-looking statements is both incomplete and unsystematic which are scattered in a host of legal documents. It suggests that CSRC may well consider issuing a systematic guidance on this issue. Besides the purpose of explicitly stating regulatory body’s philosophy towards different categories of forward-looking information and providing companies detailed requirements to invoke safe harbor protection, this guidance may also facilitate courts in adjudicating civil compensation cases arising from improper disclosure of forward-looking information. The essence of this proposal represents a role shifting in analyzing the appropriateness of forward-looking statements, risks, and assumptions from court proceedings to the regulatory body,\(^{114}\) which arguably is more sophisticated in dealing with complex securities issues than judiciary in Chinese context.

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\(^{114}\) Seligman, *supra* note 78, at 1986.
In suggesting SEC’s issuance of a similar interpretative release on forward-looking information, Prof. Seligman proposed that the major topic of the release should be a particularization of what the SEC regards as appropriate disclosure of risks and assumptions in each of the categories of required or encouraged forward-looking statements. This suggestion may also shield some light on CSRC’s specific guidance. In short of the institutions like judicial precedents and SEC no-action letters as quasi-precedents, both the Chinese practitioners and judiciary will face a difficult task on what actually is adequate disclosure that can invoke safe harbor protection and what is not. Taking forward-looking statements in MD&A as an illustration, the current rule requires the issuer to disclose the sources of its last three years’ profits as well as the trends or events that may have an impact on its continuous and stable earning capacity. This rule is targeted at the cases where companies’ past attractive profits are largely attributed to an extraordinary or one-shot business transaction, therefore by disclosing the source of profits, investors may come to understand that such an opportunity may not easily be attained again so that historical attractive performance is hard to be replicated. It suggests that the CSRC may well add a few examples to illustrate its implicit well-meaning efforts in making this rule, so that not only companies can have a clearer picture in doing compliance tasks, but investors may also be able to better evaluate companies’ disclosure.

These illustrative examples may mainly come from three sources. First is ‘pure hypothetical illustrations’ designed by CSRC’s staffs. Second, CSRC may selected some typical cases

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115 Seligman, supra note 78, at 1981.
117 Standard No. 1, art 93(2).
happened in reality. Third, CSRC can also invite market’s collective wisdom through a public consultation process before finalizing its interpretation. An interesting point is that increasing numbers of Chinese securities lawyers have been trained in U.S law schools. It is expected that these experienced professionals both have the incentive and ability to provide an array of such examples appropriately transplanted from copious cases tackling the same issue in U.S securities regulations for CSRC’s reference.

CSRC’s enforcement effectiveness has been long under criticism and voices from both academia and investors have been arguing that CSRC should have ‘real teeth’. It is admitted that regulator’s ex post rigid enforcement is an indispensable component for a sound securities market, the role of ex ante guidance for market participant’s compliance cannot be ignored.119 Merely focusing on enforcement without providing much guidance for issuers on how to properly disclose forward-looking information and leave them to ‘explore’ an appropriate way by trial and error will definitely mitigate their willingness of voluntary disclosure. On the other hand, merely providing companies with guidance without building an effective enforcement mechanism against misleading and fraudulent disclosures will largely undermine the value of forward-looking information because investors know that such statements are prone to be manipulated in an environment where anti-fraud enforcement is loose. In summary, the regulator

118 It is an undeniable fact that increasing numbers of Chinese law graduates and legal practitioners have studied, are currently studying or plan to study in the U.S. In fact, studying U.S law seems to have become a global trend. In 2004-05, for example, almost one thousand students were enrolled in graduate LL.M degree program at the top ten U.S law schools. See CURTIS J. MILHAUPT & KATHARINA PISTOR, LAW AND CAPITALISM: WHAT CORPORATE CRISES REVEAL ABOUT LEGAL SYSTEM AND ECONOMIC DEVELOPMENT AROUND THE WORLD? 214 (2008)

119 Scholars researching Chinese securities regulation from a comparative perspective have focused much on U.S SEC’s ex post enforcement, while largely ignoring SEC’s ex ante endeavor in providing market participant’s detailed explanations to guide their compliance. These ex ante endeavor mainly include SEC’s interpretative letters and no-action letters, which are of particular value for practitioners. See. e.g., Seligman, supra note 79, at 1986. (The SEC long has long displayed considerable ability in helping issuers and registrants avoid litigation through extrajudicial techniques as no-action or interpretative letters)
should spend its limited budgets wisely on both *ex ante* compliance guidance and *ex post* enforcement.

4. Civil Liability arising from Improper Forward-looking Information Disclosure

Though recent days have witnessed an unprecedentedly intensifying crackdown against securities market misconduct,\(^{120}\) disgruntled investors still have to face a number of difficulties in seeking justice by instituting civil compensations cases. Such private litigations are largely guided by the 2003’s cornerstone judicial interpretation issued by the Supreme People’s Court (hereinafter ‘Interpretation’), which sets out the detailed procedural rules for courts’ dealing civil compensation cases arising from false statements in securities market.\(^{121}\) Though the detailed provisions of this seminal interpretation is beyond the scope of this article, relating to our discussion of forward-looking information, the article nevertheless suggests that if investors intend to resort to this interpretation to institute private litigations against issuers for improper disclosure of forward-looking information, it suggests that one major revision that should be carried out is the rules governing ‘scienter’ requirement. The current interpretation, arguably


\(^{121}\) Though the first article of PRC Securities Law (both 1998 old PRC Securities Law and 2005 new PRC Securities Law) have articulated that one purpose for enacting the law is to protect investors, the civil compensation cases instituted by the aggrieved investors based on fraudulent statement were rare before the SPC’s issuance of judicial interpretation, because the lower courts were not able to accept such category of cases due to both the lack of detailed procedural rules and instruction from the Supreme Court not to accept such cases. SPC’s judicial interpretations regarding these cases are actually composed of three consecutive interpretations. The SPC issued the first circular on 21 September, 2001 instructing lower courts to continue to ignore all civil compensation claims arising from insider trading, market manipulation and other securities fraud. Then four months later, the SPC issued the second circular generally allowing lower courts to accept compensation claims arising from misstatement but not insider trading, market manipulation. It was only until 9 January 2003 that the SPC issued ‘Several Provisions of the Supreme People’s Court on Hearing Civil Compensation Cases Arising from False Statement on the Securities Market’ which sets out the detailed procedural rules for lower courts’ dealing of false statement cases. For a deep discussion of this rule, see. e.g., Sanzhu Zhu, *supra* note 74.
only designed to tackle misstatements of factual information rather than forward-looking one, articulates two mechanisms of liability attribution, i.e. ‘strict liability’ and ‘no faculty liability’. If the defendants are promoters, issuers, listed companies or controller (either controlling shareholder or non-controlling ones but who nevertheless can exercise actual control over the company), they are subject to strict liability and thus are not entitled to any statutory defense. While for securities underwriters, listing sponsors, professional intermediaries like law firms and accountant firms, and issuer’s responsible directors, supervisors and managers of issuers, securities underwriters and sponsors, they shall bear joint and several liability unless they are able to prove they are faultless for misstatement. It argues that neither ‘strict liability’ or ‘no-fault liability’ is appropriate for civil compensation cases arising from forward-looking statements, because these two attributions don’t fit for the intrinsically uncertain nature of forward-looking statements and are overly burdensome for companies. In light of the proposed safe harbor discussed above, it proposes that a ‘fault liability’ mechanism shall be added to the interpretation for the specific purpose of dealing cases involved forward-looking statements. Here ‘fault’ may be illustrated by facts such as companies’ failure to offer a reasonable underlying assumption based on which its projection was made, or the companies’ actual knowledge that the disclosure is misleading or fraudulent.

Despites CSRC’s endeavor in administrative enforcement and different bodies’ rule-making efforts, the problem that has always obsessed the Chinese investors is how to put the

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122 Interpretation, art.21.
123 Interpretation, art.21.
124 Interpretation, art. 23.
125 Ibid
126 Interpretation, art.24.
127 Interpretation, art. 23, 24.
propaganda-like investor protection provision into actual practice, in another word, how to facilitate disgruntled investors to seek deserved compensation. Besides the technical hurdle such as that investors could only launch a civil suits only after the defendant has been sanctioned administratively or criminally, or institutional shortcomings like lack of class action mechanism, it argues that the deeper root resulting in government or judiciary’s impassive attitude towards investors’ private litigation is the interwove relationship between law and politics around Chinese securities market. Thus, it is asserted that it would be more likely for China to build an effective shareholder compensation regime arising from external forces rather than from its own internal initiative. In 2009 Chinese Central Government strategically approved Shanghai’s application to turn the city into a major international financial center which can take rank with New York, London and Hong Kong in 2012. In the political context of contemporary China, this means that the city’s ambition has become a national project and both the central and local governments will combine resources to achieve this goal. In fact, the authority clearly keeps one thing in mind: investor protection is a cornerstone for a sound financial regulatory environment. It expects that the country’s ambition of this prospective landscape may play a role of external momentum for China to prioritize investor protection in its agenda for building this financial hub.

V. Concluding Remarks

Investors may value company’s forward-looking information more than its historical fact because after all, investors are buying company’s tomorrow rather than yesterday or today. The unique feature of forward-looking information, namely it cannot be accurately verified <em>ex ante</em>, determines a different regulatory approach comparing with that governs factual statements. The article perceives that although empirical studies have documented an decrease in numbers of voluntary disclosure of earnings projections since 2001 when CSRC adjusted its regulatory philosophy, with the progress of reform of China IPO mechanism and further financial liberalization, it is expected that the stock market frenzy will cool down and a balance between demand and supply for new shares will be achieved.\(^{131}\) We shall see a real competition for limited market resources and thus the companies will have more incentive to disclose forward-looking statements so as to make themselves stand out from others and thus attract investors’ money more easily. Therefore, the time is ripe for rethinking the current framework governing forward-looking information to get prepared for this incoming trend.

Based on a review and evaluation of current rules tackling forward-looking information in Chinese securities market, the article directs the reforms in two ways. One is the design of <em>ex ante</em> safe harbor and the other is <em>ex post</em> liability scheme. It proposes a two-step procedure to go through before the safe harbor protection can be invoked. It also argues that, as contrary to some Chinese scholars’ views, there is no sound justification for excluding safe harbor from IPO

\(^{131}\) In fact, during to the bearish Chinese stock market during these years, a cool down of previous frenzy for new shares could already has been observed. For example, an already-launched IPO ‘Nanning Baling’ was cancelled in June, 2011 due to the failing to attract bids from the required 20 institutions during bookbuilding, destroying the myth that IPO in china could never fail. Also, figures from Dealogic show that 54 of the 126 mainland China-listed IPOs above $50 million U.S.D fell on their first day in the after-maket so far to June, 2011. See. IPO Fails as Chinese Investors Bust Myth, <em>Financial Times</em>, June 9, 2011, at page 17.
prospectus, which arguably is the stage where the investors have the most desire to attain issuer-made forward-looking statements. However, regulation alone won’t be enough to create a favorable environment for forward-looking information disclosure. In supplement, more favorable policies should be introduced to facilitate the growth of institutional shareholders and market intermediaries, such as securities analysts and investor advisers, because comparing with retail investors, they have more incentive to gain such information and also ability to conduct an meaningful ‘anatomy’ of forward-looking information. It recognizes that China has built a quite comprehensive framework of administrative sanctions against improper disclosure while still leaves the civil compensation suits brought by aggrieved investors ineffective, albeit a quite comprehensive judicial interpretation tackling civil compensation issue. It would be difficult to have a dramatic change of this appointment within a short time in light of the perplexing interwoven of law and politics in Chinese securities market. Nevertheless, it is visualized that with the goal to building Shanghai into a world financial hub in 2012, the government clearly understands one of the paramount task on its agenda: creating an investor-friendly environment. This may insert some pressure on the regulator so as to translate the law-on-books to law-in-practice more effectively.