Regulation FD-Fairly Disruptive? An Increase In Capital Market Inefficiency

Peter Talosig III*
REGULATION FD—FAIRLY DISRUPTIVE? AN INCREASE IN CAPITAL MARKET INEFFICIENCY

Peter Talosig III*

INTRODUCTION

Motorola: I want to review for you the things that we said on the conference call.

Analyst: Okay.

Motorola: All right. Two weeks ago we said [in a press release] that orders and sales in this segment were expected to be significantly lower than the guidance at the beginning of the quarter.

Analyst: Hmm.

Motorola: Now when Motorola uses the word “significantly,” maybe you’re not familiar with this, but it’s a longstanding approach that we have, we are referring to a rate of change of 25% or more.

Analyst: Okay.

* Associate, Brewer & Pritchard, P.C; LL.M., Securities and Financial Regulation, 2003, Georgetown University Law Center; J.D., M.B.A., 2002, Syracuse University; B.B.A., 1998, Baylor University. I would like to thank Mr. Philip G. Feigen, Adjunct Professor of Law at Georgetown University Law Center and partner in the Business Law Practice Group of Patton Boggs, LLP in Washington, D.C. for his gracious insight and assistance with this project. I would also like to thank my parents, Drs. Pedro & Socorro Talosig, for their many years of support during my academic career.
Motorola: [Y]our model for that segment is showing two billion eight-hundred-thirty million, that’s only down twelve and one half percent.

Analyst: Yes.

Motorola: Okay. So there’s one place right away where your sales assumption is more optimistic than we indicated it should be two weeks ago.

Analyst: Thank you.¹

The above excerpt—taken from In the Matter of Motorola, Inc.²—is illustrative of how issuers sometimes “guided” analysts with their economic models. Immediately after the private telephone call, the stock analyst revised his earnings model in lieu of the new definition of “significantly” he learned from Motorola’s Investor Relations Director (“IRD”).³ Specifically, the analyst “lowered his PCS revenue expectation from $2.830 billion, a decline of 12.5% year-over-year, to $2.330 billion, a decline of 28% year-over-year.”⁴ This analyst was one of approximately fifteen analysts directly contacted by Motorola’s IRD between March 6 and 12, 2001.⁵ All of the analysts directly contacted by the IRD revised their models following the calls.⁶ During the time Motorola’s IRD was contacting the analysts, Motorola’s stock dropped more than 15%, from $17.70 to $15.00.⁷ There was evidence of significant trading volume at the firms where the analysts worked.⁸ Those investors who were affiliated with the analysts to whom Motorola conveyed the information were able to sell their stock before the price

². Id.
³. Id.
⁴. Id.
⁵. Id.
⁶. Id.
⁷. Id.
⁸. E.g., id.
fell, thus protecting their investment. Meanwhile, the investing public sat idly as their stock dropped and their fears rose. Public investors were at a loss to explain the sudden drop in stock price without any public news announcement by Motorola. Although the public knew that Motorola’s sales would be down “significantly,” they did not know that meant 25% or more. Motorola’s use of code words to selectively disclose information to analysts allowed them to trade with better information which the investing public was not privy to. Instances such as the one described above are not new to Wall Street and have allegedly occurred several times in the past decades.

Many retail investors complained the investment playing field was tilted unequally in favor of investment analysts and their clients because companies selectively disclosed material information, many times earnings forecasts (as was the case in Motorola), to analysts before the news was released to the public. This practice allowed a select few to trade ahead of the investing public. Although investors perceived the practice of selective disclosure as unfair, it was not illegal under Supreme Court precedent. The SEC sought to skirt precedent by creating new issuer disclosure duties.

In October 2000, the Securities and Exchange Commission (“SEC”) promulgated Regulation Fair Disclosure (“Reg. FD”), requiring issuers to disclose investment information to everyone or not at all. The rule prohibits public companies from selectively disclosing material,

9. S.E.C. Issues a Report of Investigation Concerning a Series of Selective Disclosures of Material Nonpublic Information by Motorola, Inc., S.E.C. NEWS DIG., Nov. 25, 2002, at 8 (stating that during the period of the IRD’s telephone calls, there were significant increases in the trading volume of Motorola stock at most of the firms where analysts were contacted).

10. See Arthur Levitt, Take on the Street: What Wall Street and Corporate America Don’t Want You to Know—What You Can Do to Fight Back 89 (Pantheon Publishing 2002) (citing examples of leaps in companies’ share prices in the 1990’s as a result of information disclosed to analysts).

11. See generally id. at 90 (stating that when analysts received inside information, their brokerage firms would trade on that information).

12. See Dirks v. S.E.C., 463 U.S. 646 (1983) (holding that in the absence of any personal benefit, no tipper liability extends to the insider who selectively disclosed material nonpublic information or the analyst who recommended trading in the company’s stock to clients).

nonpublic information to a select few, such as investment analysts, prior to releasing it to the public.\textsuperscript{14} For example, if Motorola wanted to explain to analysts that "significantly lower" meant "25\% or more," Motorola should have disclosed this information simultaneously to the public when Motorola called the analysts. The regulation was adopted to address what the SEC perceived to be the problem of public companies selectively disclosing information to Wall Street professionals at the expense of Main Street lay investors.\textsuperscript{15} On November 25, 2002 the SEC issued a Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 which concluded that Motorola communicated material nonpublic information to selected analysts when it quantified earnings information that had been previously disclosed only in vague qualitative terms.\textsuperscript{16}

Early critics of Reg. FD argued the regulation could have the adverse effect of restricting the quantity and quality of information companies disclose because of fears of noncompliance.\textsuperscript{17} They further argued that the chilling effect on disclosure would affect Main Street because less disclosure meant fewer informed investment decisions.\textsuperscript{18} In addition, they maintained that if Reg. FD limits selective disclosure, it does so at a great cost because investors will be less informed about a company's performance and will not lead to fairer, more efficient markets that Reg. FD proponents advocated.\textsuperscript{19} Market analysts perform an invaluable role in capital markets: they collect information, analyze and process it, and report it in a form easily digestible by the investing public.\textsuperscript{20} If analysts no longer receive information from the companies they cover, analysts' reports become less accurate and the public who purchases these reports suffer.\textsuperscript{21} Unfortunately, the rule leaves open many unresolved issues that need to be answered.\textsuperscript{22}

\begin{itemize}
\item[14.] Id.
\item[15.] See LEVITT, supra note 10, at 88--90.
\item[16.] See Motorola, supra note 1.
\item[17.] See LEVITT, supra note 10, at 94.
\item[18.] Id.
\item[19.] Id.
\item[20.] Id. at 69.
\item[21.] Id.
\end{itemize}
This article addresses the negative consequences of Reg. FD with specific attention to the effect on efficiency and volatility of the capital markets. Not only do I discuss the validity of Reg. FD’s critics’ concerns, but I examine another issue they do not consider: efficiency. Although Reg. FD was passed to enhance the flow of market information, it did so at the expense of market efficiency. I argue that although the SEC’s ban on selective disclosure might make the markets appear more fair, it is not because investors who purchase investments buy them at a discount which reflects the risks of selective disclosure. If the stockholders lose money as a result of selective disclosure, they do so knowing this potential risk and thus lose their bet.

Part I discusses the proposed regulation, former SEC Commissioner Arthur Levitt’s reasons for enacting the rule, and the various stakeholders’ responses to the regulation. In addition, this part reviews the revisions as a result of industry concerns that led to the drafting of the final rule. Last, this part will discuss Reg. FD’s operation. Part II examines recent enforcement actions brought by the SEC and an analysis of what may be learned from these actions. Part III questions the validity of Reg. FD supporters’ and opponents’ concerns in light of recent empirical research regarding the “chilling” of information, stock volatility, earnings forecast accuracy, and others. Part IV introduces the efficient capital market theory, its importance to the economy, investment market, and securities regulation, and its criticisms. Part V analyzes how Reg. FD diminishes the analyst’s role in the investment market to the detriment of efficient markets and how, if selective disclosure and trading were allowed, it would contribute to more efficient markets. Additionally, I highlight other advantages for allowing selective disclosures and trading on such information. Last, I challenge Reg. FD supporters who advocate selective disclosure is not fair. This article then concludes with a brief analysis of how efficiency should prevail over fairness and how the SEC, in its attempt to cure a perceived harm, instead brought injury to the capital markets and the people whom it sought to protect.
Chairman Levitt believed that selective disclosure had gotten out of hand in the 1990's and put small investors at a serious disadvantage to analysts and other market players who received information on corporate earnings ahead of the public.\textsuperscript{24} Levitt believed that practice was wrong, plain and simple.\textsuperscript{25} The former chairman believed Reg. FD was an audacious move and noted it was overwhelmingly opposed by the securities industry.\textsuperscript{26} Even some of Levitt's colleagues at the SEC had misgivings about FD.\textsuperscript{27} Levitt had to continuously and actively oppose a "lobbying blitz" by Reg. FD opponents, which even consisted of meeting then Senate Banking Committee Chairman Phil Gramm.\textsuperscript{28} Levitt convinced Gramm that Reg. FD would make the markets more efficient by making sure that everyone had the opportunity to get the same information at the same time. Gramm agreed to not to interfere with Reg. FD.\textsuperscript{29}

Levitt stated that he had firsthand experience as a former broker and investment banker with companies that sometimes leaked news to analysts.\textsuperscript{30} He recalled one chief executive who used the analyst at Levitt's firm to leak earnings-per-share information in the hope that the analyst would write a favorable report and push the stock through the firm's brokers.\textsuperscript{31} Levitt noted that for the next two decades companies increasingly leaked earnings information to analysts.\textsuperscript{32} He stated companies did this to avoid missing analysts' consensus forecast.\textsuperscript{33}

\begin{itemize}
  \item \textsuperscript{23} See LEVITT, supra note 10, at 87.
  \item \textsuperscript{24} Id.
  \item \textsuperscript{25} Id.
  \item \textsuperscript{26} Id. at 93.
  \item \textsuperscript{27} Id. at 88.
  \item \textsuperscript{28} Id. at 93.
  \item \textsuperscript{29} Id.
  \item \textsuperscript{30} Id. at 89.
  \item \textsuperscript{31} Id.
  \item \textsuperscript{32} Id.
  \item \textsuperscript{33} Id.
\end{itemize}
Chairman Levitt recognized that current law did not expressly prohibit selective disclosure. Levitt recruited the help of a prominent securities professor from Columbia University School of Law, Harvey Goldschmid, to help formulate an SEC rule to combat selective disclosure. Instead of focusing on insider trading, Goldschmid turned to the part of the securities laws that allowed the SEC to regulate communications between public companies and the market. Levi and Goldschmid's end product became Regulation Fair Disclosure.

B. The Proposed Legislation

Reg. FD was first proposed by the SEC in December 1999. The SEC proposal was made pursuant to its statutory authority under Section 13(a) and Section 15(d) of the Securities Exchange Act of 1934 ("Exchange Act") to mandate continuing disclosure of issuers who were registered under Section 12 or 15(d) of the Exchange Act. The proposal required that whenever: (1) an Exchange Act-registered issuer, or any person who acting on its behalf, (2) discloses material nonpublic information (3) to any person outside the issuer (other than a person who held a duty of trust or confidence not to disclose such information), (4) the issuer must (a) simultaneously (for intentional disclosures), or (b) promptly (for non-intentional disclosures) (5) disclose the information to the public. In proposing Reg. FD, the SEC stated three policy concerns: (a) to maintain investor confidence in the fairness and

34. Id. at 91.
35. Id. at 92.
37. 15 U.S.C. § 78m(a) (2004) (granting the SEC the power to require that issuers file such information and documents required to keep current the information and documents required to be filed with application or registration statement and any annual or quarterly reports as well as duplicative copies of all).
40. See id.
integrity of the securities markets,¹⁴ (b) to minimize conflicts of interests among analysts and the issuers which might seek to curry favor with analysts in return for favorable coverage,⁴² and (c) to update the securities laws to reflect “revolutions in communications and information technologies [which] have made it much easier for issuers today to disseminate important information broadly and swiftly.”⁴³ In the Proposed Rule, the SEC recognized Congress’ intent “to promote disclosure of honest, complete, and correct information to facilitate the operation of fair and efficient markets.”⁴⁴ Congress’ goal of “[f]ull and fair disclosure of information by issuers of securities to the investing public is a cornerstone of the federal securities laws.”⁴⁵ The SEC cited a number of additional justifications for the Proposed Rule. First, corporate management may be tempted to treat inside information as a commodity to be used to garner favor with particular analysts.⁴⁶ The rule relieves any pressure for an analyst to report favorably about the company. By requiring issuers to publicly disclose private information disclosed to analysts, this requirement helps eliminate the possibility that companies will delay corporate disclosure thereby allowing management discretion in “selectively disclos[ing] the information to curry favor or bolster credibility with particular analysts or institutional investors.”⁴⁷ Second, full disclosure encourages analysts to become more diligent in finding corporate information, whereas selective disclosure encourages analysts to revise their earnings estimates based primarily on corporate insiders guidance, instead of analysts’ independent research.⁴⁸ Many commentators have feared that analysts reports are biased optimistically for those companies who selectively disclose inside information to analysts, thus threatening analysts’ independence.⁴⁹ Companies have been known to “black list” certain analysts from receiving inside

---

¹⁴. See id.
¹⁵. See id.
¹⁶. See id.
¹⁷. See id.
¹⁸. Id.
¹⁹. See id.
²⁰. Id.
²¹. Id. ("[I]f selective disclosure were to go unchecked, opportunities for analyst conflicts of interests would flourish.").
²². Id.
information if they issue unfavorable reports on companies' stock.\textsuperscript{50} Last, recent technology has enabled rapid disclosure of information to the investing public.\textsuperscript{51} This technology has arguably replaced the need for information intermediaries such as analysts.\textsuperscript{52}

The proposed Reg. FD did not require immediate public disclosure of all material developments of a company as they occurred.\textsuperscript{53} Instead, the proposal required issuers who disclosed material nonpublic information to do so "broadly to the investing public, not selectively to a favored few."\textsuperscript{54} Further, the proposal did not define the term "material" and merely cited the all too familiar definition established in \textit{TSC Industries, Inc. v. Northway, Inc.} which stated that information is considered material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision, or if it would have "significantly altered the 'total mix' of information made available."\textsuperscript{55}

\textbf{C. Response to the Proposed Reg. FD}

\textit{I. The Investing Public}

The proposal sparked much controversy within the financial industry\textsuperscript{56} but received a warm reception from individual, retail

\begin{itemize}
\item[50.] Amitabh Dugar & Siva Nathan, \textit{Analysts' Research Reports: Caveat Emptor}, \textit{5 J. INVESTING} 1, 13 (1996) (citing examples of companies refusing to respond to analysts requests for information).
\item[51.] See Selective Disclosure, \textit{supra} note 39.
\item[52.] \textit{Id.} (listing available technologies for reaching the public).
\item[53.] \textit{Id.}
\item[54.] \textit{Id.}
\item[55.] \textit{Id.} (quoting TSC Industries, Inc., v. Northway Inc., 426 U.S. 438, 449 (1976)).
\end{itemize}
investors. Many securities market professionals and lawyers opposed the rule for many reasons including liability concerns, a "chilling effect" on information distribution, and volatility. These concerns will be addressed throughout this Article.

The SEC received nearly six thousand public comments after proposing Reg. FD. The vast majority of these comments were from lay investors who expressed their violent opposition to selective disclosure. For example, one investor proclaimed, "Stop selective disclosure now! It is really selective collusion to defraud the small investor." Another remarked, "I was shocked and appalled [sic] to learn that our country, 'the land of the free' still allows the major brokerage houses on wallstreet [sic] access to information which is withheld from the rest of the country for several days." And another exclaimed, "I am an individual investor, and to be frank, I am amazed that such selective disclosures were not already illegal. Why should some analysts have access to information that I can not? Are they somehow better than I am, more privileged than I? I think not!"

Other lay investors agreed with the SEC’s justifications of Reg. FD. Some commentators noted that the technology available today allows everyone to hear financial information at the same time. One commentator shared, "In this day and age of computers and lightning information, the playing [sic] fields needs to be even for everyone." These commentators expressed that the "online revolution has created a greater demand, expectation, and need for delivery of market

58. See, e.g., Arthur Zeikel Letter, supra note 56.
60. See id.
information.\textsuperscript{66} Other commentators have shown disdain towards analysts who cannot do their jobs without the help of inside information. In particular, one commentator remarked, "If Wall Street analysts cannot do their job without private information supplied to them, then what function do they serve?"\textsuperscript{67} Some commentators believed that analysts who hold inside information commit insider trading for the benefit of themselves or their clients.\textsuperscript{68} However, other commentators still value the need for analysts by using their experience and education to provide value to lay investors. As one commentator observed, "Wall St. analysts do not in any way qualify for special treatment in the disclosure of information. However, the added value of the Wall St. community should be in the breadth of their research and opinion (i.e., expectations of a company within an industry, or an industry within an economy, etc.)."\textsuperscript{69} Still other commentators have exclaimed their willingness to bypass analysts' help, and invest on the commentators' own research. One frenzied investor proclaimed, "I am a private investor with no tie to the financial community, and I find it appalling and arrogant that the purported experts in the field of investing feel that we cannot understand and filter raw corporate data on our own without their expert analysis."\textsuperscript{70} These commentators often voiced the theme that the security analyst's work would be more objective and accurate if selective disclosure were prohibited.\textsuperscript{71} In sum, investors stated the practice of selective disclosure was unfair and many likened it to a form of insider trading.\textsuperscript{72} Even some security market participants recognized the problems associated with selective disclosure and supported the SEC's proposed rule.\textsuperscript{73}

\textsuperscript{66} See Selective Disclosure, supra note 39.
\textsuperscript{71} See generally supra notes 60–69 and accompanying text.
\textsuperscript{72} See supra notes 60–62, 66–67 and accompanying text.
\textsuperscript{73} See generally supra notes 60–69 and accompanying text.
2. The Securities Industry

a. The Association for Investment Management and Research

Numerous security industry participants commented on the SEC’s Proposed Rule. Perhaps one of the largest opponents to the Proposed Rule was the Association for Investment Management and Research (AIMR). AIMR is a nonprofit organization with over 50,000 investment practitioners and educators worldwide.\(^7\) AIMR’s stated mission is “[t]o lead the investment profession globally by setting the highest standards of education, integrity, and professional excellence.”\(^7\) AIMR’s members include portfolio managers, securities analysts, consultants and strategists who often carry the prestigious certified financial analyst (CFA) designation.\(^7\)

In April 26, 2000 AIMR sent a lengthy comment letter to the SEC explaining its position on Reg. FD. AIMR acknowledged that it supported increased dissemination of information, but recognized that Reg. FD would not achieve that goal because of the negative impact Reg. FD would have on investment professionals.\(^7\) AIMR stated that the public’s view that investment analysts frequently receive inside material information from companies is false, and that this perception stemmed from the public’s “misunderstanding of the role of investment professionals.”\(^7\) In addition, contrary to the SEC’s view that the rule would increase company information to the public, AIMR believed the rule would decrease both the quality and quantity of information because issuers would constantly be on their guard with respect to what they say and to whom they speak.\(^7\) If companies are asked hard questions, AIMR quips, companies would hide behind the rule to avoid answering, or would simply relay “boilerplate language” or “sound bites.”\(^8\)

---

\(^7\) See Association for Investment Management and Research’s website, at http://www.aimr.org/support/about/ (last visited Feb. 24, 2004) [hereinafter Association for Investment Management].

\(^7\) Id.

\(^7\) Id.

\(^7\) See Arthur Ziekel Letter, supra note 56.

\(^7\) Id.

\(^7\) Id.

\(^7\) Id.
AIMR believed that the SEC would better understand AIMR’s position if it explained the role of analysts in the capital markets and how they evaluate and interpret information and repackage into a “mosaic” that is used by investors to make their investment decisions. Analysts gather data from a large variety of resources such as regulatory filings, 10-Ks and 10-Qs, the media, and people. Analysts use their skill, intuition, and perception to “ferret out” seemingly innocuous bits of information to a lay investor, that, when amalgamated with other nuggets of information, are highly informative to the investment decision-making process. Analysts, because of their experience, may “see” the big picture before others and are better able to recognize when public corporate information “rings false” to the information analysts have gleaned from other sources. Analysts are proactive and often bypass company contacts to seek information from contractors, suppliers, customers, and even competitors to garner pieces of a puzzle from which to build their “mosaic.” The AIMR recognized that while lay investors could complete their own mosaic, analysts, because of their education and experience, probably are more effective.

Even though analysts receive corporate information from many avenues, AIMR is concerned that Reg. FD would greatly discourage one-on-one communications with issuers preventing disclosure of not material information but information “to fully understand the company’s background and culture, to gain perspective about trends and developments.” In addition, certain valuable information disclosed by companies such as business strategy is often complicated and takes “research, consideration, interpretation, and dialogue” that can only be elicited in one-on-one communications. AIMR believed this dialogue to be crucial for the critical dissemination of information to the public.

AIMR also believed that Reg. FD would significantly alter the flow of information to investors because the rule shifts the burden of

81. Id.
82. Id.
83. Id.
84. Id.
85. Id.
86. Id.
87. Id.
88. Id.
89. Id.
determining what is material to the issuer.\textsuperscript{90} AIMR argued that issuers would be forced to consider more thoroughly and precisely what information is likely to be deemed material to an investor which would inevitably make issuers more reticent to disclose anything because they do not know what will be "material" to investors.\textsuperscript{91} AIMR agreed with the SEC that issuers would need to make "instant materiality judgments" when fielding questions from analysts.\textsuperscript{92} AIMR also agreed with the SEC that since issuers would more than likely need to consult with their attorneys more frequently before responding to questions, Reg. FD cannot help but to curtail the issuer's willingness to answer any questions whatsoever.\textsuperscript{93} To avoid inadvertent disclosure of material information, AIMR argued that issuers would not hold private meetings any longer.\textsuperscript{94} In addition, AIMR predicted that increased use of attorneys in corporate communications would lead to increased use of "boilerplate" language and thus, reduce the amount of relevant information in disclosure documents.\textsuperscript{95} Further, corporate counsel would more than likely sanitize communications to avoid any question about a statement's materiality.\textsuperscript{96} AIMR believed that one way to reduce the need for attorneys is for the SEC to give clearer guidance on the definition of materiality.\textsuperscript{97} Unless the SEC does so, AIMR argued, issuers would continue to speak "at risk."\textsuperscript{98} In essence, if Reg. FD is implemented, issuers would curtail disclosure to the market to avoid "on

\textsuperscript{90} Id.

\textsuperscript{91} Id.

\textsuperscript{92} Id.

\textsuperscript{93} Id.

\textsuperscript{94} Id.

\textsuperscript{95} Id.

\textsuperscript{96} Id. "Counsel would most likely advise the use of formal, structured and abbreviated disclosure in order to avoid any questions about the information's materiality." Id. "Issuers will continue to speak, but no meaningful information will be communicated." Id. "We believe that such sanitized communications would continue until uncertainty about how the regulation will be enforced is diminished." Id.

\textsuperscript{97} Id. "The AIMR Task Force believes that one way to reduce the involvement of legal counsel is to develop a 'bright line' definition of materiality." Id. "At a minimum, this definition could include clear standards about what kind of information, such as earnings forecasts, would always be considered material." Id.

\textsuperscript{98} Id. "Without such standards, whenever issuers speak in other than a public forum, they will always be "at risk" regardless of their \textit{ex ante} materiality assessments." Id.
the spot" materiality determinations that the SEC may deem material after the fact.99

b. The Securities Industry Association

Another large opponent to the Proposed Rule was The Securities Industry Association ("SIA"). SIA was formed in 1972 and has over 600 securities firms in its membership.100 These firms include investment banks, broker-dealers, and mutual fund companies that participate world-wide in corporate and public finance.101 SIA "employ[s] more than 800,000 individuals, representing 97 percent of total employment in securities brokers and dealers."102

In another lengthy letter to the SEC, SIA on April 6, 2000 voiced strong opposition to Reg. FD because to its judgment, Reg. FD would discourage companies from divulging important information.103 SIA found it strange where, despite the current trend showing that issuers were opening conference calls to the public,104 the SEC would promulgate a rule that SIA finds would stymie the disclosure of corporate information.105 According to SIA, in order for issuers to avoid the problems of Reg. FD, they would eliminate meetings with analysts, become "more circumspect in what they say at open meetings," and

101. Id.
103. Letter from Lee B. Spencer, Chairman, Ad Hoc Working Group on Proposed Regulation FD, and George A. Schieren, Vice-President, Legal SIA Compliance and Legal Division, to Jonathan G. Katz, Secretary, Securities and Exchange Commission 4 (April 6, 2000), at http://www.aimr.org/advocacy/sia.html (last visited Mar. 25, 2004) (stating that "we find it very puzzling and troubling that the commission is considering a step that we believer will operate to constrict the flow of information.")
104. Id. at 3–4 (noting a recent survey by the National Investor Relations Institute that found 82% of issuers who conducted conference calls allowed real-time access to the public—up from 29% and 14% two years previous).
105. See id. at 4.
prohibit telephone conversations with analysts. These steps would result in less information for the investing public. SIA also stated that issuers who were previously reluctant to disclose information would hide behind the rule as an excuse not to talk. In addition to the numerous problems enumerated by AIMR's comment letter, SIA found other reasons why Reg. FD may not be good policy.

SIA believed the term "selective disclosure" was unnecessarily broad because it included not only disclosure to analysts for an improper "quid pro quo" but also included ordinary channels of communication with benign motives. SIA believed these communications help get information to the marketplace and are in the public's interest. In addition, SIA stated that historically, the securities regulations mandated only certain disclosure; however, the Commission is now re-writing history by requiring a "springing obligation" to disclose a material fact just because this fact was disclosed to an outsider. SIA noted that under the securities laws all investors are entitled to equal access to information for mandatory disclosure and any information issuers voluntarily disclose to the public. However, SIA was quick to note that the securities laws do not contemplate equal access to all material corporate information. In addition, SIA cited Supreme Court precedent disclaiming any right to equal information absent Congressional intent. SIA further argued that even assuming issuer compliance with Reg. FD, someone would get the information before

106. Id.
107. See id.
108. Id.
109. Id. at 5.
110. Id.
111. Id. at 7.
112. See id. at 7–8 (stating that "[t]he Securities Act and the Exchange Act contemplate a parity of access to required information and beyond that, the information the issuer chooses to include in registration statements and reports or otherwise makes public.").
113. See id. at 8.
114. See id. at 8–9. (noting that "[i]n 1980 and 1983 the Supreme Court expressly denied the Commission's authority to impose an equal information rule under Securities Act § 17 and Exchange Act § 10(b). In fact, while we cannot say whether the Court contemplated Commission action under Exchange Act §§ 13 and 15(d), it said in Chiarella and repeated in Dirks that formulation of an absolute equal information rule should not be undertaken absent some explicit evidence of Congressional intent.").
another and be able to act on it quicker. SIA proposed an example where investors who watched the first television screen on which information appeared would have a distinct advantage over one who received the information via a news alert signal. Further, the recipient of inadvertent material information would have an advantage over the world until the issuer makes a public statement. In sum, SIA concluded parity of access to material information was “illusory.”

SIA also argued that the phrase “persons acting on behalf of an issuer” was defined unnecessarily broadly to possibly include a purchasing agent who talks to suppliers about materials necessary for a unique product or even a salesman who talks to potential buyers about a fascinating new product coming to market. SIA declared that the purchasing agent or salesman would have to get a confidentiality agreement from the supplier or buyers or else the company is bound to disclose this information to the marketplace. SIA supposed that as a practical matter, it would be extremely difficult for management to constantly monitor their employees’ communications with outsiders. Further complicating the process, SIA posed the question how a “senior official” is to determine whether an employee’s comment was made intentionally or unintentionally? What if the manager did not think the comment was material and because of his busy schedule did not tell the issuer until later? When does the issuer’s duty to disclose this information commence? What if the recipient of information breaks the confidentiality agreement? Does the issuer still have to disclose publicly this information? When? SIA concluded there existed a host of practical issues that cannot easily and definitely be resolved.

115. See id. at 9.
116. Id.
117. See id. at 10.
118. Id.
119. Id. at 18.
120. See id. at 19.
121. See id. at 19.
122. Id. at 19–20.
123. See id. at 20.
124. See id.
125. See id.
126. See id.
127. Id.
128. Id. at 21.
And thus, issuers would avoid this conundrum altogether by shutting their mouths and "restricting the flow of information." 129

SIA also voiced its concerns about increased litigation risk. 130 Although SIA noted that Reg. FD expressly prohibited section 10(b) of the 1934 Exchange Act actions for Reg. FD violations, SIA believed that when an issuer makes a public disclosure it, in essence, admits that the statement is material. 131 SIA was concerned that the clever securities plaintiff's bar could make something out of this. 132 Although the SEC would take action for only egregious conduct, SIA asserted that reasonable persons could differ on the question of materiality and egregious conduct. 133

SIA concluded the costs of Reg. FD's compliance would greatly outweigh any possible benefits. 134 SIA cited the SEC's estimate that issuers would make about five public disclosures under Reg. FD per year. 135 SIA, however, proclaimed that the SEC had no factual basis for making this conservative estimate, and SIA predicted disclosures would be "in far excess of that amount." 136 SIA also argued that the costs of disclosure would be more burdensome for small issuers as opposed to large issuers because "materiality is to a large extent a function of size." 137 Most importantly, SIA pointed out the SEC failed to consider the enormous issue outside of costs to the issuer—the costs to the marketplace—in terms of increased volatility, surprise, and accuracy of stock pricing if Reg. FD does in fact limit the flow of information into the marketplace. 138 To summarize, SIA conceded that it could not quantify the costs of compliance like the SEC could not quantify the benefits of Reg. FD. 139 Therefore, SIA argued that the SEC should not engage in rule-making where "the benefits and costs of which are so

129. Id.
130. See id. at 24.
131. See id.
132. See id.
133. See id.
134. See generally id. at 30.
135. See id.
136. Id.
137. Id.
138. See id. at 31.
139. See id.
nebulous and unquantifiable and the risks and results of which are so unforeseeable.\textsuperscript{140}

3. Public Issuers

Steve Luczo, CEO of Seagate Technologies and former investment banker, believed that Reg. FD impeded the flow of quality information to the market place.\textsuperscript{141} Luczo states that, “FD, in many ways, has restricted what companies can say and how they respond. What short-sellers can do is say whatever they want, and drive the stock down a point or two. In the face of no buyers, it’s a really good business.”\textsuperscript{142} Luczo spotted a factual mistake in one analyst’s report and asked the analyst why he did not obtain verification from Seagate.\textsuperscript{143} The analyst responded that “his firm’s compliance department warned [that] he could not talk to the company.”\textsuperscript{144} Luczo noted that the analyst may just be using Reg. FD as an excuse for his own ineptness, but Luczo believed that Reg. FD had “produced a climate of fear.”\textsuperscript{145}

Other public companies are not influenced by Reg. FD to increase communications with the public. Chewing gum maker Wm. Wrigley Jr. Co. does not hold conference calls or plan to Webcast.\textsuperscript{146} “There wouldn’t be any change in the policy right now,” stated Wrigley’s Corporate Communications Director Christopher J. Perille.\textsuperscript{147} In addition, Winn Dixie Stores spokesman G. E. “Mickey” Clerc stated, “If we felt we had something we needed to talk about, then we would. There’s no set schedule.”\textsuperscript{148} Bina Thompson, Vice President of Investor Relations at Colgate-Palmolive, told SEC Commissioners at the April 2001 roundtable that Reg. FD is hampering efforts to correct wayward

\textsuperscript{140} See id.
\textsuperscript{142} Id.
\textsuperscript{143} See id.
\textsuperscript{144} Id.
\textsuperscript{145} Id.
\textsuperscript{147} Id.
\textsuperscript{148} Id.
earnings estimates.\textsuperscript{149} She also stated that companies are “fearful that individual contact with an analyst risks violation of the rule.”\textsuperscript{150} While Colgate-Palmolive does meet with analysts, it believes its public releases alone satisfy the public and SEC requirements.\textsuperscript{151} United Airlines (“United”) claimed that before Reg. FD, United “gave out more information than other airlines.”\textsuperscript{152} However, United has used the rule as an excuse to not disclose any information the Regulation does not require.\textsuperscript{153}

Some public companies, such as AOL Time-Warner, believe otherwise. AOL’s Investor Relations Vice-President Richard E. Hanlon believes some analysts are using Reg. FD “as an excuse to get grumpy.”\textsuperscript{154} He expressed, “[w]e’re always better off when more people have a better and fuller understanding of what we’re about.”\textsuperscript{155}

4. Other Commentators

Many commentators reiterated the “chilling effect” on corporate disclosures that both the AIMR and SIA announced. Because materiality judgments are difficult and risky to make, management is potentially less likely to discuss important information at all.\textsuperscript{156} These types of situations highlight the dangers of creating a “chilling effect” on releasing corporate information because of management’s reluctance to disclose anything at all for fear of making erroneous materiality judgments and being subject to liability.\textsuperscript{157} Sullivan & Cromwell, a prestigious global law firm based in New York City, commented to the

\begin{itemize}
\item \textsuperscript{150} Id.
\item \textsuperscript{151} Id.
\item \textsuperscript{153} See id.
\item \textsuperscript{154} See Weber, \textit{supra} note 146.
\item \textsuperscript{155} Id.
\item \textsuperscript{157} See Norm Alster, \textit{Tight Lips Sink Stock Tips; Has Regulation FD Had a Chilling Effect on the Flow of Information from Public Companies?}, ELECTRONIC BUS., July 1, 2001 at 56.
\end{itemize}
SEC that because corporate officials must make instant materiality judgments they would preclude in-depth questioning by analysts at conference calls. This firm feared that this practice "would discourage enterprising analysts from digging as deeply into corporate affairs as they are permitted to do under current standards and practices." The firm decried Reg. FD would prevent talented analysts from differentiating themselves from others. Additionally, issuers would adhere to a script vetted by its counsel to avoid disclosing material information. The increasing formalization would lead to a significant negative effect on the scope and quality of disclosures because of a lack of "give-and-take discussion and communication of nuances" that are not readily available in public documents.

Other commentators questioned the need for such a rule. They argued the SEC's justifications for the rule consisted of very little evidence of selective disclosure. In addition, the SEC cited no empirical study of issuer disclosure practices. In fact, the current trend was that issuers were opening up their conference calls to investors. A survey by the National Investor Relations Institute found that sixty one percent of survey participants were broadcasting their conference calls over the Internet for access by individual investors.


159. Id.

160. See id.

161. Id.

162. Id.


164. Id.; see also Arthur Zeikel Letter, supra note 56.

165. See Letter from Cleary, Gottlieb, Steen & Hamilton, supra note 163.


167. Id.
One commentator raised constitutional concerns declaring that Reg. FD would "compel speech" contrary to Supreme Court precedent. Other critics argued that the new regulation would lead to "information overload" where issuers may decide to err on the side of caution by disclosing both material and nonmaterial information. If analysts no longer "ferret out" important information, lay investors may be burdened by too much information and might not be able to properly analyze the information and make appropriate trading decisions. Other commentators argued that Wall Street information would be "dumbed down" for lay investors. Fidelity Investments has vociferated that Reg. FD "drags smart mutual-fund analysts down to the level of the masses because they can no longer ask in private the thoughtful questions that give them an edge."

D. Final Regulation

I. SEC's Response

The SEC took the opponents' criticism into account which led the SEC to revise the Proposed Rule by narrowing its scope, but kept its main provisions intact. Despite the enormous controversy, the SEC adopted its Final Rule on August 10, 2000 and became effective on October 23, 2000.

171. See Marissa P. Vicarro, Comment, Can Regulation Fair Disclosure Survive the Aftermath of Enron?, 40 DUQ. L. REV. 695, 700 (2002) (noting various commentators who state financial information has become less informative).
172. Id. (citing Opdyke & Schroeder, supra note 149).
173. See General Rule, supra note 13.
174. Id.
2. Enter Commissioner Laura Unger

The SEC rule was not a unanimous decision: the SEC passed Regulation FD three to one, with then Commissioner Laura Unger strenuously dissenting.175 Unger, a Republican, reiterated the "chilling effect" the rule would have on corporate disclosure of information into the marketplace.176 According to Unger, while the SEC has "bet the store" that Regulation FD would work, she has "bet her house"177 that it would not.178 She further stated that "Regulation FD turns on its head the longstanding relationship between issuers and analysts."179 The Commissioner believed that Reg. FD was a communication rule that was formed to cure a trading problem—trading based on selective disclosure.180 She believed that "in its attempt to eradicate actual trading by clients of analysts following a selective disclosure, Reg. FD burdened the vast majority of issuers, who are good corporate citizens, with new disclosure requirements."181 In addition, Commissioner Unger was concerned about the quality and quantity of information that would be disseminated after the rule's effectiveness.182

Commissioner Unger vowed to vigorously monitor Reg. FD's effect on information flow.183 Without the changes to Reg. FD, Unger may have had support from Commissioner Hunt. In a speech before the American Society of Corporate Secretaries on June 30, 2000, Hunt

175. See LEVITT, supra note 10, at 88.
177. Id.
178. Id.
179. Id.
181. Id.
182. Id.
183. Id.
stated that Reg. FD as proposed “would be extremely costly to corporations and provide little benefit to investors.”

3. Revisions to Narrow Scope of Regulation FD

To quell commentators’ fear about the likelihood of any chilling effect on corporate disclosure or inappropriate liability, the Commission modified Regulation FD in several ways. First, the Commission narrowed the rule to not include communications to all persons outside of the issuer. Instead, the rule disallows communications only to securities markets professionals and anyone “[w]ho is a holder of the issuer’s securities under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer’s securities on the basis of the information.”

Second, the Commission addressed issuers’ concern about ordinary business communication. Reg. FD only applies to issuer personnel such as “any senior official of the issuer... or any other officer, employee, or agent of an issuer who regularly communicates with any person described in sections 243.100(b)(i), (ii), or (iii), or with holders of the issuer’s securities.”

Third, the Commission removed any doubt about private liability by including an express provision in the text stating that “[n]o failure to make a public disclosure required solely by section 243.100 shall be deemed to be a violation of Rule 10b-5 under the Securities Exchange Act.”

Fourth, the SEC provided additional assurance that issuers will not be second-guessed on close materiality calls. The Commission stated that liability arises only when the issuer “knows, or is reckless in not
knowing, that the information he or she is communicating is both material and nonpublic.\footnote{192} In addition, the Commission attempted to comfort issuers by stating that SEC enforcement actions under Reg. FD would not occur for mistaken materiality determinations that were not reckless.\footnote{193} However, the SEC refused to delineate a "bright line" test and instead, relied on existing case law definitions for materiality.\footnote{194} The SEC argued that the materiality standard needed "flexibility" to fit the facts and circumstances of each case and thus, refused a bright line rule for fear of the rule being over- or under-inclusive.\footnote{195} The Commission did provide a non-exclusive list of some types of information or events that should be reviewed carefully to determine their materiality;\footnote{196} however, the Commission warned that list did not imply that each of those items were per se material.\footnote{197} Further, the SEC attempted to comfort issuers by stating that issuers are not prohibited from disclosing non-material information to analysts even if, unbeknownst to the issuer, the information helps the analysts to complete a "mosaic" which, in itself, is material.\footnote{198}

Fifth, the SEC expressly provided that a Reg. FD violation would not lead to an issuer's loss of eligibility to use short form registration or its ability to resell under Rule 144 of the Securities Act of 1933.\footnote{199} This provision helped ease issuers' concern for collateral consequences of

\footnote{192}{17 C.F.R. § 243.101(a) (2004).}
\footnote{193}{Id.}
\footnote{194}{See Selective Disclosure, supra note 39.}
\footnote{195}{Id.}
\footnote{196}{See Final Rule: Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, available at http://www.sec.gov/rules/final/33-7881.htm (last visited Mar. 25, 2004) [hereinafter Insider Trading] (listing various areas of concern, such as: earnings information; mergers, acquisitions, tender offers, joint ventures, or changes in assets; new products or discoveries, or developments regarding customers or suppliers; changes in control or management; change in auditors or auditor notification that the issuer may no longer rely on an auditor's report; events regarding the issuer's securities—e.g., defaults on senior securities, stock splits or changes in dividends; and bankruptcies or receiverships).}
\footnote{197}{Id. "By including this list, we do not mean to imply that each of these items is per se material." Id. "The information and events on this list still require determinations as to their materiality." Id.}
\footnote{198}{Id.}
\footnote{199}{Id.}
Reg. FD violations. To help foreign issuers' concerns about Reg. FD, the SEC excluded foreign issuers from coverage of the regulation.\textsuperscript{200}

4. Reg. FD's Operation

As mentioned in part I. A. above, whenever (1) an issuer, or person acting on its behalf, (2) discloses material nonpublic information, (3) to certain enumerated persons (broker/dealers, investment advisers, investment companies, and holders of issuer's securities), (4) the issuer must make a public disclosure of the same information either (a) simultaneously in the case of intentional disclosure, or (b) promptly (generally within 24 hours\textsuperscript{201}) for non-intentional disclosures.\textsuperscript{202} A disclosure is considered intentional "when the person making the disclosure either knows, or is reckless in not knowing, that the information . . . is both material and nonpublic."\textsuperscript{203} No public disclosure is necessary if (1) the recipient of the information owes a duty of trust or confidence not to disclose (such as an attorney or accountant), (2) confidentiality agreement exists, (3) disclosure is made to a credit agency, or (4) the disclosure is made in connection with a registered offering under the Securities Act.\textsuperscript{204}

Rule 101(e) defines the types of acceptable "public disclosure" satisfying Reg. FD. The rule states that issuers make public disclosure under Reg. FD by filing or furnishing a Form 8-K, or by disseminating information "through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public."\textsuperscript{205} The SEC notes that either filing or furnishing information on Form 8-K to satisfy Reg. FD will not be deemed an admission as to materiality of that information.\textsuperscript{206} As such, issuers may choose to "file" a report under Item 5 of Form 8-K or to "furnish" a report under Item 9 of Form 8-K.

\textsuperscript{200} \textit{Id.}
\textsuperscript{201} 17 C.F.R. § 243.101 (2004) (noting that in cases of non-intentional disclosures over the weekend or holiday prompt disclosure may be made the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange).
\textsuperscript{202} \textit{Id.}
\textsuperscript{203} 17 C.F.R. § 243.101(a) (2004).
\textsuperscript{204} 17 C.F.R. § 243.100 (2004).
\textsuperscript{205} 17 C.F.R. § 243.101(e) (2004).
\textsuperscript{206} 17 C.F.R. § 249 (2004).
that will not be deemed "filed." If an issuer chooses to "furnish" the information, it will not be subject to liability under Section 11 of the Securities Act or Section 18 of the Exchange Act, unless the issuer includes the disclosure in a filed report, proxy statement, or registration statement. Issuers are able to utilize alternative methods or combination of methods of public disclosure that is "reasonably designed to provide broad, non-exclusionary distribution of the information to the public." Acceptable methods include press releases distributed widely through a news or wire service, or press conferences or conference calls accessible to the public by listening in person, by telephone, or other electronic means such as the Internet. Issuers must give the public adequate notice of the conference and adequate means to access it. Although a website, by itself, may not be a sufficient means of public disclosure, the SEC notes that a website could be a part of a combination of methods to distribute information to the public.

On March 28, 2003, Regulation G became effective. Reg. G requires public companies which disclose or release non-GAAP financial measures to include in that same disclosure or release, a presentation of the most directly comparable GAAP financial measure and a reconciliation of the non-GAAP financial measure to the most directly comparable GAAP financial measure. Reg. FD and Reg. G operate in tandem. A private communication of material, non-public information to a corporate outsider triggers a public disclosure requirement under Reg. FD. If that private communication is of material information containing a non-GAAP financial measure, Reg. G applies to that disclosure. For example, if an issuer selectively discloses to an analyst that its sales per square foot or same store sales (both non-GAAP financial measures) will increase/decrease, then this disclosure requires public dissemination: 1) under Reg. FD because material nonpublic

207. Id.
208. Id.
211. Id.
212. Id.
214. Id.
information was intentionally and selectively disclosed, and 2) under Reg. G because the disclosure did not include a directly comparable financial measure presented in accordance to GAAP.\textsuperscript{215} Form 8-K was amended to include Item 12, Disclosure of Results of Operations and Financial Condition.\textsuperscript{216} Item 12 requires issuers to furnish to the SEC a Form 8-K within five business days of any public announcement or release disclosing material non-public information regarding the issuer’s financial condition for an annual or quarterly fiscal period that just ended.\textsuperscript{217} Item 12 requirements will apply regardless of whether the release or announcement includes disclosure of a non-GAAP financial measure.\textsuperscript{218} In the above example, the public issuer who selectively disclosed non-GAAP information to the analyst would be required to file a Form 8-K which disclosed the contents of the conversation (to fulfill Reg. FD) and to provide a comparable GAAP financial measure and a reconciliation of the private non-GAAP financial measure and the comparable GAAP financial measure (to fulfill Reg. G).

An issuer who fails to disclose the material information is subject to SEC Enforcement Actions alleging violations of Section 13(a) or 15(d) of the Exchange Act and Reg. FD.\textsuperscript{219} The SEC can bring administrative actions seeking cease-and-desist orders, or file a civil suit with a federal district court seeking injunctions and money penalties.\textsuperscript{220} In addition, the SEC can specifically charge the individual at the company who committed the violation, either as a “cause of” the violation in a cease-and-desist proceeding, or as an aider and abettor of the violation in an injunctive action.\textsuperscript{221} Unlike Rule 10b-5 violations which impose criminal sanctions, Reg. FD imposes no criminal penalty.\textsuperscript{222} Additionally, no private right of actions exists for issuer violations of Reg. FD.\textsuperscript{223}

\textsuperscript{215} See id.
\textsuperscript{216} Id.
\textsuperscript{217} Id.
\textsuperscript{218} Id.
\textsuperscript{221} Id.
\textsuperscript{222} Id.
\textsuperscript{223} See id.
II. SEC ENFORCEMENT ACTIONS

More than two years after Reg. FD's effective date, the SEC Enforcement Division brought its first set of enforcement actions under the rule. On November 25, 2002 the SEC instituted cease-and-desist orders against Secure Corp., Raytheon, Co., and Siebel Systems. All companies settled their actions with the SEC, and only Siebel paid a $250,000 fine.

A. Secure Computing Corporation

Secure is a high-technology company that is engaged in selling Internet security-related products. John McNulty had been the CEO and Chairman of the Board since July 1999. In early 2000, Secure contracted with a computer networking company ("the buyer") to bundle Secure's product along with the buyer's network systems. No public announcement was made. The contract specified that Secure would not make press releases without the buyer's consent. Consent was contingent upon the buyer's sales force obtaining customer testimonials and feedback from "beta customers" which could be used in the press release. On March 6, 2000 at the buyer's request, Secure posted a


227. See id.

228. See id.

229. See id.

230. See id.

231. See id.

232. See id.
private page on its website to allow buyer’s sales force and beta customers to access software downloads.\textsuperscript{233}

Secure Computing invited interest in its stock among institutional investors through in-person presentations and conference calls.\textsuperscript{234} McNulty led many of these meetings.\textsuperscript{235} On March 6, 2002 McNulty called from his home a portfolio manager at an investment firm while McNulty’s investor relations director (“IR”) listened to the call from her office.\textsuperscript{236} In addition, a salesperson from a brokerage firm (“salesperson”) that followed Secure arranged and attended the telephonic meeting.\textsuperscript{237} McNulty was asked questions about the product, and he asked permission from the IR to answer.\textsuperscript{238} The IR was unaware McNulty was referring to the buyer and gave permission to speak.\textsuperscript{239} McNulty then disclosed the name of the buyer, the agreement between them, and the secret website address (in violation of buyer’s consent agreement).\textsuperscript{240} During the meeting the IR realized McNulty was disclosing material nonpublic information yet she did not interrupt McNulty.\textsuperscript{241} The conference call finished at 11:00 a.m. (PST). After the meeting was over, she left a voicemail on McNulty’s phone discussing his disclosure of nonpublic information.\textsuperscript{242}

The CEO’s disclosure was the first time the salesperson heard of the agreement regarding Secure’s product.\textsuperscript{243} He quickly relayed the information to his office.\textsuperscript{244} Afterwards, the managing partner of the salesperson’s brokerage firm e-mailed McNulty to inquire further.\textsuperscript{245} McNulty returned the e-mail disclosing the secure website address and exclaimed, “There won’t be a[n] announcement/press release until [the buyer] has some customer references—bottom line though it ain’t

\begin{thebibliography}{99}
\bibitem{233} See id.
\bibitem{234} See id.
\bibitem{235} See id.
\bibitem{236} See id.
\bibitem{237} See id.
\bibitem{238} See id.
\bibitem{239} See id.
\bibitem{240} See id.
\bibitem{241} See id.
\bibitem{242} See id.
\bibitem{243} See id.
\bibitem{244} See id.
\bibitem{245} See id.
\end{thebibliography}
 Shortly thereafter, McNulty received the IR’s voicemail, and McNulty e-mailed the managing partner requesting that he keep the information confidential. Secure made no public announcement that day and its stock price rose 8% over the previous day’s close.

The next morning, Secure received many inquiries about the agreement. McNulty did not tell the buyer about his inadvertent disclosure and plead for consent to a public disclosure. The buyer did not agree. Later that morning, McNulty had another conference call with an institutional investor who asked about the agreement with the buyer. McNulty confirmed the agreement. Secure’s stock price increased 7% from March 6’s close. That same day at 1:40 (PST), following the market close, Secure issued a press statement disclosing the agreement with buyer. The next day, March 8, Secure’s stock rose another 7% on high volume.

The SEC charged Secure with violating Reg. FD and McNulty as the cause of such violation. The SEC determined the disclosure was material and nonpublic. It also concluded that the March 6 disclosures were non-intentional, thus requiring Secure to make prompt disclosure. The SEC found that the March 7 disclosure was intentional because it was made three hours before the press release. The SEC concluded the disclosure violated Reg. FD because it was not made simultaneously to the market.

The SEC, pursuant to its Section 21(c) of the Exchange Act authority, ordered Secure to cease and desist from committing and causing future violations of Reg. FD and Section 13(a) of the Exchange Act.

246. See id.
247. See id.
248. See id.
249. See id.
250. See id.
251. See id.
252. See id.
253. See id.
254. See id.
255. See id.
256. See id.
257. See id.
258. See id.
259. See id.
260. See id.
The SEC used the same authority to order McNulty to cease and desist from causing any future violations of Reg. FD and Section 13(a). No penalties were imposed. Both Secure and McNulty settled and consented to the above order.

B. Raytheon Company

Raytheon is a leading defense company. Franklyn A. Caine was its Chief Financial Officer from 1999 to 2001. Raytheon maintained internal quarterly earnings per share ("EPS") estimates, which Caine frequently received. Caine also monitored outsiders' consensus earnings projections of Raytheon as reported by Thompson Financial/First Call ("First Call"), a security research firm. On February 9, 2001, First Call released Raytheon consensus earnings estimates of $0.31 per share. In mid-February, Raytheon's internal EPS measured $0.28, or $0.03 lower than consensus estimate.

On February 7, 2001, Raytheon conducted a public investor conference in which it reiterated annual EPS between $1.55 and $1.70 but it did not mention its first quarter EPS. After the conference, Caine ordered his staff to retrieve earnings models from sell-side analysts who contributed to First Call's consensus estimate. Caine also ordered his staff to schedule one-on-one conferences to discuss quarterly projections. Between mid-February and March 5, 2001, Caine met with 11 of the 13 analysts. Caine disclosed that Raytheon's 2001 quarterly earnings distribution would be similar to the same

261. See id.
262. See id.
263. See id.
264. See id.
265. See Raytheon Company, supra note 224.
266. See id.
267. See id.
268. See id.
269. See id.
270. See id.
271. See id.
272. See id.
273. See id.
274. See id.
275. See id.
seasonality trend found in 2000. In other words, Caine disclosed that one third of its earnings would come in the first half of the year and the remaining earnings would come in the second half of the year. Analysts previously believed Raytheon’s earnings would be more balanced throughout the year. They then revised their earnings estimates by moving more earnings to the second half of the year. In addition, Caine specifically commented on their first quarter projections. For example, Caine told one analyst that his first quarter projection was “too high.” Caine told two analysts that their projections regarding certain Raytheon’s business divisions were “aggressive” or “very aggressive.” These analysts lowered their first quarter revenue and EPS estimates. On another occasion, Caine e-mailed an analyst’s assistant who, after a week, still did not revise the firm’s estimates. Caine remarked, “When we spoke about your model, I think we said you should expect our earnings profile to be about the same as it was in 2000—that is, we generated about one-third of our EPS in the first half of the year. I notice that you’re WAY above that.” After the one-on-one conversations, all eleven analysts downwardly revised their estimates for Raytheon’s first quarter EPS and submitted their revisions to First Call. The average downward change was $0.05 resulting in a new consensus earnings estimate of $0.27. In April of 2001, Raytheon posted first quarter EPS of $0.28, beating The Street’s estimate. In a public conference, Raytheon stated that it was “pleased to report another quarter of progress toward our goal of restoring your confidence in our company.”

276. See id.
277. See id.
278. See id.
279. See id.
280. See id.
281. See id.
282. See id.
283. See id.
284. See id.
285. See id.
286. See id.
287. See id.
288. See id.
289. See id.
the fifth straight quarter we have met or exceeded our commitments to you."

On Feb. 26 and 28, 2001, Caine had a one-on-one conversation with a sell side analyst who subsequently lowered his first and quarter EPS estimates. On March 1, 2001, that analyst participated in a "morning call" with the firm's institutional sales force. That analyst disclosed to the sales force that 1) he was lowering Raytheon's first quarter EPS estimate, 2) Raytheon might be suffering from cash flow problems worse than the Street realized, and 3) to the analyst's belief, the Washington Group may seek from Raytheon remuneration for the purchase of a certain Raytheon business. After the morning call, the sales force e-mailed to their institutional clients the substance of the morning call's discussions. That day, institutional clients sold more than 2 million shares of Raytheon stock. After the March 1 morning call, Raytheon's Class B stock fell 6% and Class A stock fell 3%.

The SEC charged Raytheon with violating Reg. FD and Caine as the cause of such violation. The SEC determined the disclosures were material by reason of the subject matter of the information: earnings guidance. The disclosures were found to be nonpublic because at no time before or during the first quarter of 2001 did Raytheon publicize any guidance regarding its first quarter EPS or its 2001 earnings guidance. The SEC also found that at no time did Raytheon publicly disclose Caine's earnings guidance disclosures to the analysts.

The SEC, pursuant to its Section 21(c) of the Exchange Act authority, ordered Raytheon to cease and desist from committing and causing future violations of Reg. FD and Section 13(a) of the Exchange Act. The SEC used the same authority to order Caine to cease and
desist from causing any future violations of Reg. FD and Section 13(a).\textsuperscript{302} No penalties were imposed.\textsuperscript{303}

In one part of this Release, the SEC stated they did not need to discuss the issue of "whether the trading and price decline of Raytheon's stock on March 1, 2001 was caused by Raytheon's earnings disclosures."\textsuperscript{304} Evidently, the SEC concluded it had enough evidence that the disclosures were material without the need to examine whether a drop in stock price could be a factor to determine materiality in this case.\textsuperscript{305} In other words, the Commission believed that the materiality of Caine's nonpublic disclosure was so clear that the movement in Raytheon's stock was a non-issue.\textsuperscript{306} Furthermore, when Caine told analysts that their estimates were not in line with Raytheon's internal projections that alone was enough to find a Reg. FD violation.\textsuperscript{307}

C. \textit{Siebel Systems, Inc.}\textsuperscript{308}

Siebel Systems, Inc. ("Siebel") is a provider of customer relationship management (CRM) software and other business applications.\textsuperscript{309} On October 17, 2001, Siebel posted its third quarter earnings.\textsuperscript{310} During the third quarter, both sales and earnings had declined compared to the same quarter the previous year causing it to miss analysts' earnings estimates.\textsuperscript{311} In a public conference call, Siebel's CEO stated, "Things have been tough. We think that they will be quite tough in the short term. We have an exceptionally soft market for information technology.... Spending for tech products and services continues to slide. We expect things will be quite tough through the remainder of the year."\textsuperscript{312}

\textsuperscript{302} See id.
\textsuperscript{303} See id.
\textsuperscript{304} See id.
\textsuperscript{305} See id.
\textsuperscript{306} See id.
\textsuperscript{307} See id.
\textsuperscript{308} See Siebel Systems, \textit{supra} note 224.
\textsuperscript{309} See id.
\textsuperscript{310} See id.
\textsuperscript{311} See id.
\textsuperscript{312} See id.
Three weeks later, an analyst at Goldman Sachs approached Siebel about participating in a technology conference which featured a question-and-answer session between Siebel’s CEO and the analyst, and then follow up questions by the audience. Siebel’s CEO agreed to attend. Thereafter, Goldman Sachs provided Siebel with a list of questions the analyst planned to ask including whether Siebel had “any evidence that the software market [was] getting any better or worse” in the fourth quarter. Goldman Sachs also sent an attendance lists of nearly 200 individuals including broker-dealers, investment advisers, investment companies and institutional shareholders.

On November 2, 2001, Siebel’s CEO and Investment Relations Director (“IR”) had a brief conference call with the analyst to discuss last minute preparations for the conference on November 5. After the conference and unbeknownst to Siebel, the analyst drafted an internal report which he circulated within Goldman Sachs which stated, “[a]fter speaking with management, we think there is a good chance [the Company’s CEO] sets a positive tone at our software conference . . . . It seems as if business activity has increased . . . and this data point will likely be taken positively this morning.” Later that evening, Siebel’s IR prepared talking points to the CEO and CFO for use at the technology conference. The talking points contained only public information and did not discuss the analyst’s question regarding the software market. Siebel’s CEO attended the technology conference on November 5. After a brief introduction, the analyst moderator asked the CEO about how the software business looked in October and whether the customers are getting back to normalcy. The CEO replied, “[T]he business decisions appear to be quite normal right now, and so we’re pretty optimistic about what we’re seeing at this time . . . . [S]o right now it appears we’re seeing a return to normal behavior in IT

313. See id.
314. See id.
315. See id.
316. See id.
317. See id.
318. See id.
319. See id.
320. See id.
321. See id.
322. See id.
The analyst then asked about sales throughout the previous quarter. The CEO replied, "I think the linearity of this Q4 will be about what we saw in Q4 of the previous two years. It was, the behavior of the market appears normal..." Siebel did not disclose this information to the public. The conference was not accessible via the Internet nor did the company file a Form 8-K or make any other public disclosure. On October 11, 2001, several weeks before the technology conference, the IR learned that the conference would not be webcast. The IR did not disclose this information to the CEO. On the day of the technology conference, Siebel's stock rose 16.5% higher over the previous day's close. There was also evidence that attendees purchased stock during the CEO's question-and-answer session. The SEC charged Siebel with violating Reg. FD. Siebel knew the conference's attendees were "person[s] outside the issuer" because it previously received an attending list of various securities professionals. The SEC determined from the CEO's comments that the Company was "pretty optimistic" because it was witnessing "a return to normal behavior in IT buying patterns" and that "the linearity of this Q4 will be about what we saw in Q4 of the previous two years" were material because it altered the total mix of information to an investor. These statements contrasted with his earlier statements. Then, the CEO stated the company was facing "an exceptionally soft market for information technology" and that things would remain "quite tough" for the rest of the year. The disclosures were found to be nonpublic because when the CEO made his optimistic comments at the technology conference, he was speaking about sales in

323. See id.
324. See id.
325. See id.
326. See id.
327. See id.
328. See id.
329. See id.
330. See id.
331. See id.
332. See id.
333. See id.
334. See id.
335. See id.
336. See id.
his company's own "sales pipeline." The CEO responded to a question in which the analyst referenced Siebel's use of its own software to track its "sales pipeline." The SEC also stated Siebel's disclosures were intentional because it knew or was reckless in not knowing the disclosures were material and nonpublic where Siebel's IR knew the technology conference would not be webcast and failed to tell the CEO.

The SEC, pursuant to its Section 21(c) of the Exchange Act authority, ordered Siebel to cease and desist from committing or causing future violations of Reg. FD and Section 13(a) of the Exchange Act. Siebel agreed to pay a $250,000 fine. What is unknown is why Siebel agreed to pay the $250,000 fine. It seems that Secure's McNulty participated in more egregious conduct because he intentionally disclosed information where Siebel's CEO's disclosure was more inadvertent. The fact that Siebel's CEO or IR were not made parties to this administrative proceeding supports the argument that Siebel's conduct was less malevolent.

D. Analysis of the Enforcement Cases

Unfortunately, the SEC in these enforcement actions did not provide any more light as to what constitutes materiality. The SEC has repeated in the past that it is not their role to define materiality. The SEC has deferred to the common law definition of materiality. In these cases, material disclosures were not hard to find. In Secure Corp. the sales agreement disclosure would likely alter the total mix of information available to an investor. In both Raytheon and Siebel, earnings disclosures would be considered important to an investor in making an investment decision. The SEC also based its materiality determinations upon what the recipients of the selectively disclosed information did with the information and the effect on the price and

337. See id.
338. See id.
339. See id.
340. See id.
volume of the issuer’s stock after private disclosure. For example, in Siebel’s case, the SEC carefully detailed Siebel’s stock price reaction during the CEO’s presentation at the technology conference and noted that several analysts purchased large blocks of stock during the presentation. Thus, a company can monitor market reaction after a private disclosure to help it make a materiality determination. If the market reacts, it is more likely the information was material and an immediate public disclosure should be contemplated.

Another concern for companies is that their confidential business transactions can cause Reg. FD problems. Secure was stuck between a rock and a hard place because it was under a contractual obligation to not disclose the deal and yet because of the beta testing it had to post some information on its website. Issuers should negotiate contractual provisions to allow public disclosure if mandated by Reg. FD.

Companies should also watch their use of code words as in the Motorola case discussed earlier in this Article. In Motorola, the IR told the analyst that “significant” meant “25%.” The SEC again highlighted that it considers earnings guidance to be problematic. Motorola told the analyst that revenue would decrease “significantly” (i.e., “25%”).

What is more problematic is that the SEC named Secure’s CEO’s as a defendant and the SEC failed to include the IR. The facts stated that the IR gave permission for the CEO to speak in response to the portfolio manager’s question. Only during the CEO’s response did the IR notice the CEO asked permission regarding another subject matter. The SEC said that the IR acted on behalf of the issuer thereby

342. See, e.g., Siebel Systems, supra note 224 (noting the positive effects on Siebel’s stock after Siebel’s CEO delivered a speech at the technology conference).
343. See id.
344. See Secure Computing, supra note 224.
345. Id.
346. See Motorola, supra note 1.
347. Id.
348. See id. (warning against the selective disclosure of earnings information during private conversations with analysts).
349. Id.
351. See id.
352. See id.
353. See id.
imputing her liability to the issuer, Secure. It seems that the IR should share in some responsibility for the disclosure yet she was not named. Perhaps the SEC only named Secure’s CEO because he was the one who made the verbal disclosure. The SEC’s punishment in the Secure, Siebel, and Raytheon cases were relatively light compared to other enforcement actions.\textsuperscript{354} Motorola probably did not receive a cease-and-desist order because it relied on good faith on the erroneous opinion of its general counsel.\textsuperscript{355} The SEC warned that corporate executives cannot always rely on its general counsel because they may have “a keener awareness than company counsel of the significance of information to investors.”\textsuperscript{356}

Reg. FD punishment is expected to become more stern in the future.\textsuperscript{357} Professor Miller believes punishments will become more severe over time once executives become more familiar with Reg. FD.\textsuperscript{358} But, he does recognize that hard cases will realize in the future over efforts to punish more-ambiguous statements.\textsuperscript{359} “The hard case is going to come up... when the atmospherics do say something indirectly. That’s going to be the proving ground.”\textsuperscript{360} The author notes that cease-and-desist sanctions may have little deterrent effects because unlike Section 10(b) and Rule 10b-5 violations, Reg. FD has no criminal penalties.\textsuperscript{361} If Raytheon, Secure, or Siebel violate Reg. FD again, they cannot receive criminal punishment.\textsuperscript{362} These companies may have no incentive to comply with Reg. FD because its punishment “has no teeth.”\textsuperscript{363}


\textsuperscript{355} See Motorola, supra note 1.

\textsuperscript{356} Id.


\textsuperscript{358} See id.

\textsuperscript{359} Id.

\textsuperscript{360} Id.

\textsuperscript{361} See id.

\textsuperscript{362} See id.

\textsuperscript{363} Id.
Since Reg. FD’s enactment, numerous studies have been conducted to assess the rule’s impact on the market. Many studies have been conducted to analyze whether commentators’ fears about Reg. FD were warranted. True to her word, Commissioner Unger convened a roundtable discussion to monitor the impact of Reg. FD and commissioned a study.

A. Commissioner Unger Revisited

At a public meeting adopting Reg. FD, the SEC agreed to monitor the rule to determine if it chilled corporate communications or had any other negative consequences. The Commission convened a roundtable discussion on April 24, 2001, six months after Reg. FD’s effective date, where it heard from issuers, analysts, investors, law professors, and SEC Staff. After the roundtable, Commissioner Unger continued to monitor Reg. FD and later issued a report which summarized the views of the roundtable discussion, identified issues of concern, and made recommendations for improving Reg. FD.

Unger reported that the issue of materiality dominated roundtable discussions. Panelists expressed concern about what kinds of “earnings information” may be deemed material. Concerns concentrated on three items: confirmation of prior guidance, disclosure of product-related and other non-financial information, and correcting outdated analyst estimates. In addition, panelists requested clarification.

---

367. Id.
368. See Unger, Regulation Fair Disclosure Revisited, supra note 365.
369. Id.
370. The panelists’ concerns were justified. Their concerns regarding confirmation of prior guidance, disclosure of product-related and other non-financial information,
regarding whether plant and factory tours would trigger Reg. FD disclosure obligations. Unger recommended the Commission draft an interpretive release to discuss the Commission’s position on materiality further and to address the concerns of the panelists. The commissioner also suggested that if future enforcement actions are brought, the SEC could use that opportunity to discuss its views on materiality under Reg. FD. As discussed in the previous section, the SEC failed to provide additional guidance on materiality. Although the Commission sought to quell fears about Reg. FD liability in the roundtable discussions, Unger stated that few issuers and corporate counsel have taken comfort from the SEC’s assurances. The roundtable revealed that most panelists agreed that uncertainty regarding materiality has urged them to err on the side of caution. This uncertainty, proponents argued, makes it difficult for analysts to complete the mosaic.

Commissioner Unger also noted concerns by issuers who requested more options in publicly disclosing information because the SEC does not allow website postings alone to satisfy Reg. FD. Unger also heard complaints that although Reg. FD provides a number of choices for issuers to disseminate information, current SRO rules prescribe issuers’ use of press releases to disclose material information thus eliminating Reg. FD’s flexibility. Unger recommended that the Commission work with SROs and more openly embrace technology to allow noticed website postings, publicly accessible webcasts, and electronic mail alerts.

The roundtable discussions revealed debate regarding whether more information was available after Reg. FD. Some issuers stated more information was available whereas sell-side analysts stated the opposite. In addition, both sides disagreed as to whether Reg. FD led to a decline in quality of information. Certain panelists articulated that some issuers used the rule as a shield to hide information and that some issuers have resorted to scripted presentations. Although eight surveys discussing the quantity/quality debate were reviewed, these surveys had differing results. As a result of the panelist discussions, Unger recommended in her report that the Commission examine both the amount and type of information being disclosed by issuers through Form 8-K’s, webcasts, filings, press releases, and other modes of dissemination.

and correcting outdated analyst estimates were in fact the subject of the SEC enforcement actions. See Unger, Regulation Fair Disclosure Revisited, supra note 365.
Unger concluded her report by noting that although Reg. FD may have accomplished its goal of equal access to information, that goal may have come at a great cost. Unger notes how some issuers, investors, and analysts state that Reg. FD has “caused issuers to say nothing, analysts to hear nothing, and investors to see nothing."  

Unger believed that once the Commission made it more clear which types of information it wanted issuers to disclose to the public, dialogue between issuers and analysts would increase which would bring more information to the market place. In addition, Unger recommended the Commission should expand and clarify ways issuers may use technology to disclose nonpublic information.

B. Information Overload

Some commentators believe that Reg. FD would cause issuers to disclose too much, rather than not enough. Many commentators predicted that Reg. FD would cause companies to disclose “minutia.” One potential negative impact of Reg. FD argued by various commentators was that the rule would produce significantly greater information available to the public resulting in an “information overload.” Companies may decide to err on the side of caution by disclosing both material and non-material information. Opponents of the rule forecasted that Reg. FD would produce a torrential flow of information to address the materiality issue by issuers releasing information regarding everything and anything.

Investors already have difficulty parsing the voluminous amounts of financial information available on the Internet. One recent estimate found that “every online investor has access to over three billion pieces of financial data,” and “those who are willing to pay have access to over

371. See id.
373. See Unger, Rethinking Disclosure, supra note 169 (discussing adverse effects of too much information in the market).
374. Id.
375. See General Rule, supra note 13, at 51,716.
280 billion pieces.” Sophisticated investors such as analysts routinely scour tomes to retrieve and interpret relevant data. But are lay investors capable of performing the same work? Although lay investors may be technologically sophisticated to use the Internet, they may not be sophisticated enough to make appropriate investment decisions. An abundance of information does not ensure that investors can effectively digest that information. Psychological studies show that individuals are more likely to make decisions based on easily recalled information rather than “more complete data sets.” Therefore, individuals overreact to recent or vivid information. This overreaction leads to overconfidence in an individual’s predictive abilities. They overstate their ability to see future trends, and understate the risks involved. Studies show that when individuals are given more information, their confidence in their predictions outpaces the accuracy of their predictions. Overconfidence leads to many undesirable effects. Overconfident investors may not properly diversify their portfolios because they are “sure” they are picking the right stocks. Overconfident investors tend to trade too much because they purchase stocks they believe are winners. The studies conclude: “Overconfident investors will overestimate the value of their private information, causing them to trade too actively and, consequently, to earn below-average returns.” The researchers note that the time it takes for investors “to become rational” depend on the level of feedback. They note the process is quicker for portfolio managers as

378. Id.
379. Id.
380. See Barber & Odean, supra note 376, at 46.
382. Id.
384. Gervais & Odean, supra note 381.
opposed to lay investors because portfolio managers are often subject to frequent portfolio reviews.\textsuperscript{385}

Recent studies support the idea that issuers are disclosing more information.\textsuperscript{386} Whether these disclosures are resulting in an information overload is still unknown. Although issuers are disclosing more information through Form 8-K's, many analysts believe the depth of information disclosed is rather shallow.

\section*{C. Decreased Corporate Communications with Analysts}

As noted in Section I. C. 2. supra, analysts add value to the marketplace by using their skill, intuition, and perception to "ferret out" seemingly innocuous bits of information to a lay investor and to piece together information into a "mosaic" that is comprehensible and meaningful to lay investors.\textsuperscript{387} Unfortunately, Reg. FD has negatively affected the relationships between issuers and analysts.\textsuperscript{388} In a speech at a conference by Commissioner Unger, she noted that Reg. FD adversely affected analyst and issuer relationships.\textsuperscript{389} Unger stated that analysts no longer have access to information that was available before Reg. FD and that this result leads to less accurate earnings targets.\textsuperscript{390} Three independent surveys have confirmed Unger's belief. A survey of 577 companies conducted by the National Investor Relations Institute (NIRI) found that 24\% of companies are providing less information following the enactment of Reg. FD.\textsuperscript{391} Louis Thompson, President and CEO of NIRI, stated, "Earnings guidance has become a risky area," making some companies reluctant to share information.\textsuperscript{392} In addition,
companies are less likely to review analysts' earnings estimates. The NIRI survey found that only 53% of companies review analysts' estimates after Reg. FD whereas 81% of companies reviewed estimates before Reg. FD.\textsuperscript{393} The companies that do review earnings models, however, only check for historical and factual accuracy.\textsuperscript{394} Companies have not completely eliminated one-on-one meetings with analysts. NIRI found that 74% of companies are still meeting privately with analysts despite the SEC's previous warning that issuing companies risked violating Reg. FD for one-on-one discussions.\textsuperscript{395}

An extensive survey by the Securities Industry Association (SIA) of broker-dealers, general counsels of public companies, individual investors, and SIA firms found that out of the analysts surveyed, two-thirds said the companies they covered "communicated less."\textsuperscript{396} In addition, 72% of analysts reported that the quality of information has declined.\textsuperscript{397} 90% of analysts stated companies would not talk about information that was not disclosed in press releases, Web casts, or Form 8-K's.\textsuperscript{398} 69% of sell-side analysts reported that they could no longer gather all the information to "complete the mosaic."\textsuperscript{399}

On January 31, 2001, The Association for Investment Management and Research (AIMR) conducted a Reg. FD survey seeking information from 6,142 analyst and portfolio manager respondents. 57% of those surveyed believe the volume of substantive information from the companies they research has decreased since Reg. FD.\textsuperscript{400} Only 14%
found that the volume of substantive information increased.\textsuperscript{401} 56\% of respondents reported that the quality of information disclosed by companies has decreased.\textsuperscript{402} 81\% of respondents agreed that with the enactment of Reg. FD, companies that want to minimize communication with investors can do so more effectively as compared to 27\% of respondents who believed companies want to maximize communication.\textsuperscript{403} AIMR found that 43\% of investment professional respondents had less confidence in the accuracy of their earnings forecasts since Reg. FD’s enactment\textsuperscript{404}. An AIMR Senior Vice President who directs professional standards for AIMR’s members remarked, “Clearly, many of our members feel that too many of our companies are taking an excessively conservative stance and misinterpreting the new regulation to mean they should have \textit{no} one-to-one or small-group communication with anyone at all.”\textsuperscript{405}

Recent studies regarding the “chilling” of corporate disclosure are mixed. Professor Eric Zitzewitz concluded that Reg. FD reduced selective disclosure of future earnings to analysts without reducing the total amount of information disclosed.\textsuperscript{406} Professors Christopher Blake and Patricia Williams found similar results.\textsuperscript{407} They found that the level of management quarterly earnings forecasts increased post Reg. FD with no corresponding decrease in the quality of information provided.\textsuperscript{408} The professors also found that the quality of corporate disclosures increased.\textsuperscript{409}

The author notes that Blake and Williams equated corporate disclosure with corporate earnings forecasts when conducting their study. Earnings forecasts are not the only types of information Reg. FD

\textsuperscript{401} \url{http://www.aimr.com/pressroom/01releases/regfd_survey.html} (last visited Mar. 27, 2004) [hereinafter AIMR Survey].
\textsuperscript{402} \textit{Id.}
\textsuperscript{403} \textit{Id.}
\textsuperscript{404} \textit{Id.}
\textsuperscript{405} \textit{Id.} (emphasis in original).
\textsuperscript{407} Christopher R. Blake & Patricia A. Williams, \textit{Does Reg. FD Have a “Chilling Effect” on the Quantity and Quality of Corporate Information?} (Nov. 2002) (unpublished manuscript, on file with author).
\textsuperscript{408} \textit{Id.}
\textsuperscript{409} \textit{Id.}
critics claim issuers are more reluctant to disclose after Reg. FD's effective date. Analysts inquire about other types of information aside from earnings forecasts. Recall in Commissioner Unger's report that she recommended the Commission examine both the amount and type of information being disclosed by issuers through Form 8-K's, webcasts, filings, press releases, and other modes of information. The author has not found any studies that measured the frequency of these disclosures. Although Blake and Williams found that the quality and quantity of corporate disclosures has improved post Reg. FD, their study is limited to the analysis of only one type of corporate disclosure: earnings forecasts.

Another study supports the contention that corporate disclosure has not been chilled. This study utilized conference call data and not earnings forecasts data to find their conclusion. Professors Brian Bushee, Dawn Matsumoto, and Gregory Miller found no evidence that Reg. FD reduced the amount of information disclosed during public access to conference calls.\textsuperscript{410} Other studies found different conclusions. Professors Andreas Gintschel and Stanimir Markov determined that the absolute price impact of financial analysts' forecasts is lower than 20%, suggesting Reg. FD reduced the amount of private information disclosed by managers to analyst.\textsuperscript{411} In addition, although Professors Venkat Eleswarapu, Rex Thompson, and Kumar Venkataraman concluded that Reg. FD has caused information asymmetry to increase, they noted that "information flow around mandatory announcements has decreased but overall information flow is unchanged."\textsuperscript{412}

Although the weight of the evidence from these empirical studies seems to indicate that the quantity of information has not been chilled,


perhaps the quality of information has decreased. The majority of these studies are limited in scope and utility because they focus only on earnings forecasts and not other forms of corporate disclosures that analysts believe have been chilled. Further, aside from the Williams and Blake study, the studies do not measure the quality of information. These studies do, however, suggest that issuers themselves are disclosing more internal earnings forecasts to the public. Until further research is conducted measuring other forms of corporate disclosures, we only have the NIRI, SIA, and AIMR surveys and the results of studies revolving around earnings forecasts.

D. Volatility

The connection between volatility and Reg. FD stems from the rule's affect on quantity and quality of information. Commentators frequently expressed concerns that corporations are erring on the side of caution in not providing earnings guidance to stock analysts. When analysts are unable to modify their earnings models, uncertainty in the market increases in which this higher risk is reflected in lower stock valuations. Instead of corporate information slowly leaking into the market place via its communications with analysts allowing for gradual stock price movements, public disclosures sometimes act as a dramatic bombshell on stock prices. When investors react to information that is released to the market at once, the markets suffer from severe price swings.

An example of the relation between Reg. FD and increased market volatility occurred in August, 2000. Intel realized its revenue targets


415. See India, supra note 413.


would not be met for the third-quarter.\textsuperscript{418} To comply with Reg. FD, Intel publicly announced this information instead of selectively disclosing to its analysts.\textsuperscript{419} Intel stock price fell 22%.\textsuperscript{420} A record 300 million shares were traded and $91 billion dollars in market capitalization was lost.\textsuperscript{421} In addition, Proctor and Gamble and Eli Lilly both lost 30% in market capitalization in a single day.\textsuperscript{422} Forty seven other companies in 2000 dropped 20% or more of their market capitalization in a single day.\textsuperscript{423} Just under half of those crashes came in April 2000.\textsuperscript{424} These dramatic price swings certainly do not instill investor confidence in the marketplace.

The concern for volatility arises for four reasons: (1) an increase in volatility will increase the expected risk premium thereby affecting a firm’s cost of capital;\textsuperscript{425} (2) greater volatility in firm value increases compensating differential required to retain corporate management;\textsuperscript{426} (3) value of stock options is reduced as aggregate market volatility increases;\textsuperscript{427} and (4) gives politicians an excuse to meddle in the markets.\textsuperscript{428}

The AIMR survey found that 71% of respondents believed that Reg. FD has contributed to market volatility: a lot (25%), some (34%), or a little (12%).\textsuperscript{429} Many of these respondents attribute the volatility to

\textsuperscript{419} \textit{Id.}
\textsuperscript{421} \textit{Id.}
\textsuperscript{422} \textit{Id.}
\textsuperscript{423} \textit{Id.}
\textsuperscript{424} \textit{Id.}
\textsuperscript{426} See \textit{id.} at 956 (citing Clifford W. Smith & R. Stulz, \textit{The Determinants of Firm’s Hedging Policies}, 20 J. FIN. & QUANT. ANALYSiS 391 (1985)).
\textsuperscript{427} \textit{Id.} (citing Clifford W. Smith & R.L. Watts, \textit{Incentive and Tax Effects of U.S. Executive Compensation Plans}, 7 AUSTRALIAN J. MGMT. 139 (1982)).
\textsuperscript{428} \textit{Id.}
\textsuperscript{429} See AIMR Survey, \textit{supra} note 400.
a lessening of earnings guidance and which lead to more earnings surprises.\textsuperscript{430}

Recent studies overwhelmingly conclude stock price volatility has increased after Reg. FD's effective date. Some studies have shown a correlation between higher stock market volatility and Reg. FD.\textsuperscript{431} One recent study found that stock price volatility was higher during public conference calls than private conference calls.\textsuperscript{432} The researchers found that volatility was 50\% higher during public conference calls.\textsuperscript{433} Professor Matsumoto acknowledged that she did not know what caused the increased volatility but remarked, "Whenever more information is disclosed there is an increase in price volatility . . . .\textsuperscript{434} All we can say is that greater volatility is consistent with many managers' concerns that allowing smaller, less savvy investors open access to information could lead to misunderstandings that would lead investors to sell their shares in the company."\textsuperscript{435} Another study discovered similar results. A study by Professor Selim Topaloglu found that for positive earnings surprises, price sensitivity to missed earnings targets is larger post-Reg. FD.\textsuperscript{436} On the other hand, Topaloglu found that the markets do not respond to negative earnings surprises much differently in the Reg. FD era.\textsuperscript{437} Topaloglu believes this is attributed to the reported increase in earnings warnings pre-announcements after Reg. FD.\textsuperscript{438}

\begin{footnotes}
\item[430] Id.
\item[431] Mark I. Schwartz & Jane K.P. Tam, \textit{Fair Disclosure: How Reg FD stifles market efficiency}, Fn.\textsc{Post}, Nov. 21, 2001 (noting increased volatility is a consequence of information being disclosed in "fits and starts").
\item[433] Id.
\item[434] Id.
\item[435] Id.
\item[437] Id.
\item[438] Id.
\end{footnotes}
E. Negative Effects on Smaller Corporations

Corporate relations with securities analysts are very important for small companies because analysts provide market interest in the companies. Many smaller companies rely heavily on analyst forums to gain coverage of their stocks. Some critics argue that Reg. FD will decrease the amount of information smaller companies disclose at these forums resulting in less popularity of these companies. In a hearing before Congress, Daniel P. Hann, representing the Association of Publicly Traded Companies testified that Reg. FD would have a disproportionate impact on small and new public companies. Hann conveyed that small companies often struggle to get coverage by stock analysts. Hann further declared, "It is a simple function of human nature that an analyst with only marginal interest in a company will react negatively to being told, 'Let me get back to you on that question after I talk to my lawyer.'"

F. Decreased Analyst Earnings Forecast Accuracy

Professors Shyam Sunder and Partha Mohanram found that after Reg. FD's effective date, analysts earnings forecast errors increased. Their study showed that analysts' raw absolute error increased from 4.9 cents in the pre-FD period to around 6.2 cents in the post-FD period. This amounts to a 26.53% increase in analysts' error. In addition, the study confirmed that analysts' forecast dispersion, or the standard deviation of forecasts at any particular point in time, had increased.

440. Id.
441. Id.
442. See Hann's Statement, supra note 414.
443. Id.
444. Id.
446. Id.
significantly.\textsuperscript{447} The professors downplayed the significance of these findings by noting that macroeconomic factors, such as the Internet bust, probably contributed more to the increased analyst error and forecast dispersion than Reg. FD.\textsuperscript{448} The professors also noted that analysts are reducing the number of firms they are covering which is consistent with their need to conduct more research.\textsuperscript{449} Another study discovered that earnings forecasts issued early in quarters after Reg. FD are less accurate than in quarter's prior to Reg. FD.\textsuperscript{450}

Professors Anup Agrawal and Sahiba Chadha found similar results in their studies concerning accuracy.\textsuperscript{451} They found that earnings forecasts became less accurate post-Reg. FD at both the individual analyst and consensus levels.\textsuperscript{452} The two concluded that the effect was particularly pronounced in small and lesser followed firms, firms with losses, and firms in technology and consumable durables sectors.\textsuperscript{453} The study also confirmed Sunder and Mohanram's assertion that analysts' forecast dispersion increased post-Reg. FD.\textsuperscript{454} Professor Topaloglu found that analysts' forecast dispersion doubled after Reg. FD's enactment.

These studies prove that analysts' earnings forecasts for individual companies are becoming less accurate. If issuers are disclosing earnings information to the public through the press and not through analysts, then the above results are not surprising. Analysts do have a right to complain if they no longer are receiving data inputs from issuers for analysts' earnings models. Then again, Reg. FD proponents argue that analysts cannot complain about having to do more research because that is their fundamental function.

\textsuperscript{447} Id.
\textsuperscript{448} Id.
\textsuperscript{449} Id.
\textsuperscript{450} Philip Shane et al., \textit{Earnings and Price Discovery in the Post-Reg. FD Information Environment: A Preliminary Analysis} (Nov. 15, 2001) (unpublished manuscript, on file with author).
\textsuperscript{452} Id.
\textsuperscript{453} Id.
\textsuperscript{454} Id.
IV. THE EFFICIENT CAPITAL MARKET HYPOTHESIS

A. Background

For years, economists have been interested in the pricing of securities in established capital markets. The prevailing view of how financial markets work is the Efficient Capital Market Hypothesis (ECMH). Three forms of the ECMH exist. The weak form states that the current market price of a security traded in the market reflects all data about the security's earlier prices. The strong form posits that a security's price incorporates all information, regardless of whether the information is generally available to the public. The semi-strong form, the most widely accepted, states that a security's current price reflects all currently available public information. "When new information becomes available, the market absorbs and discounts it instantaneously and efficiently."

The semi-strong form holds that it is impossible for an investor to purchase an "undervalued" or "overvalued" stock because all publicly available information is already reflected in the stock price. For example, when an investor purchases a stock at price X, he does so because he feels the stock is worth more than what he pays. But if the market is efficient and stock price X reflects all public knowledge, then buying and selling the stock in an attempt to outperform the market will be more of a game of chance rather than skill. In other words, you cannot beat the market. Professor Burton Malkiel once wrote that ECMH "holds that since all available information is quickly factored into stock prices, all stocks present equal chances for gains. Taken to its logical extreme... [the theory] means that a blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio

457. Id.
458. Id.
459. Id.
460. HAMILTON & BOOTH, supra note 455, at 36.
that would do just as well as one carefully selected by the experts." ECMH is a theory followed and studied so thoroughly that "there is no other proposition in economics which has more solid empirical evidence supporting it than the efficient market hypothesis." 

B. Eugene Fama: The Father of ECMH

Although capital market efficiency has been the subject of research since the early 1900's, Eugene Fama's 1970 article on capital markets provided the first full discourse on ECMH. Eugene Fama was an early pioneer and advocate of the efficient market hypothesis. Fama argued that in an active market including many well-informed and intelligent investors, securities will be fairly valued reflecting all public knowledge. In other words, the market accurately assesses the worth of particular information and is not misled by seemingly unrelated and inconsequential bits of information. To properly assess information, one must know the information one is assessing. In fact, Fama wrote, "In an efficient market, competition among the many intelligent participants leads to a situation where, at any point in time, actual prices of individual securities already reflect the effects of information based both on events that have already occurred and on events, which, as of now, the markets expects to take place in the future. In other words... at any point in time the actual price of a security will be a good estimate of its intrinsic value." The "intelligent participants" that Fama is referring to are market insiders such as financial analysts. Fama further argued that in an efficient market, no information or analysis can help an investor outperform a benchmark index. Aside from intelligent or

465. Id.
466. See HAMILTON & BOOTH, supra note 455, at 36.
468. Id.
"rational" investors, another assumption of the ECMH is that "perfect pricing" exists.\textsuperscript{469} If "perfect pricing" is a fiction, then markets cannot reach the equilibrium price necessary for ECMH's validity. A third assumption is that news travels instantaneously.\textsuperscript{470} A stock price cannot instantaneously reflect market information unless the transmission of that information is also instantaneous. Last, ECMH assumes no one possesses monopolistic power over the market that leads to large buying.\textsuperscript{471}

\textbf{C. Criticisms and Alternate Models}

These assumptions have often been criticized. A world-renowned investor, Warren Buffet, has quipped, "I'd be a bum in the street with a tin cup if the markets were efficient."\textsuperscript{472} Economic studies have shown that "noise trading" or trading on irrelevant data often occurs in the markets.\textsuperscript{473} Noise theorists believe that many market participants act irrationally because they suffer "testable cognitive biases that impede their collective ability to coldly calculate the intrinsic value of securities."\textsuperscript{474} Another theory focusing on irrationality is called "herd behavior" where irrational investors buy and sell based upon whether other irrational investors are buying and selling.\textsuperscript{475} Some research suggests that security prices do not instantaneously reflect available

\begin{itemize}
\item \textsuperscript{470} Id. at 181.
\item \textsuperscript{471} Id.
\item \textsuperscript{475} Stephen M. Bainbridge, Mandatory Disclosure: A Behavioral Analysis, 68 U. Cin. L. Rev. 1023, 1038 (Summer 2000) (discussing herd behavior of business executives).
\end{itemize}
public information but adjust to information slowly, over time.\textsuperscript{476} For example, one study showed that dividend announcements produced a drift in share prices extending for periods up to twelve months.\textsuperscript{477} Some studies have established "anomalies" or pockets of inefficiency, which should not exist in an efficient market.\textsuperscript{478} One anomaly known as the "weekend effect" demonstrates that Monday's closing stock prices are frequently lower than the previous Friday's closing stock prices.\textsuperscript{479} Another documented anomaly is the neglected-firm effect.\textsuperscript{480} This effect states that companies, whose stock is not held by large institutional investors or followed by many financial analysts, will experience above-average rates of return.\textsuperscript{481}

\textbf{D. The Importance of ECMH}

Efficient pricing is crucial for achieving the efficient allocation of resources in the economy.\textsuperscript{482} Inefficient pricing can lead to decreased liquidity and increased risk.\textsuperscript{483} Inefficient pricing can also lead to secondary effects on the economy. Stock investors perceive the market value of stocks as a determinant of wealth. An unexpected decline in


\textsuperscript{481} \textit{Id.} at 5–6.


\textsuperscript{483} \textit{Id.} at 1034.
stock market values may lead to an investor's perception in loss of wealth which may lead to decreased spending and consumption. An aggregate decrease in spending may lead to a lower rate of economic growth which, if combined with other factors, may lead to economic recession. For example, although the stock market crash of 1987 did not lead to an economic recession, it probably had a depressing effect on economic activity.

Despite its criticism, ECMH is the prevalent economic view of securities pricing and is a major premise for a substantial body of corporate and securities law and scholarship. The Securities Exchange Commission itself has relied expressly on the ECMH for justifying its rules establishing the integrated-disclosure system and rules authorizing shelf registration of securities. The SEC has also recognized ECMH when formulating Reg. FD.

In addition, the United States Supreme Court has recognized the ECMH in securities fraud cases. In Basic v. Levinson, the Court had to decide whether an individual shareholder suing an issuer for fraud who did not rely personally on the issuer's alleged public misstatements, could presume reliance where he purchased the issuer's stock. The shareholder claimed he relied on the integrity of the issuer's stock price because of the market's "efficiency" in incorporating available information into the stock price including the issuer's alleged public misstatements.

484. Id.
485. Kahan, supra note 482, at 1035.
489. Id.
The shareholder’s theory of reliance is popularly known as the “fraud-on-the-market theory.” Justice Blackmun explained that the fraud-on-the-market theory was based on a theory that “in an open and developed securities market, the price of a company’s stock is determined by the available material information.” However, Justice Blackmun cautioned that the Court’s task was not to assess the theory’s validity, but to determine whether the lower court could apply a rebuttable presumption of reliance. The Court concluded that it was appropriate to consider other alternatives of reliance in securities litigation because transactions typically occurred though the mechanisms of large, impersonal trading markets.

The Court reasoned that a market operates as an intermediary between buyer and seller thereby relaying information to the investor in the form of a market price. The market thus, performs a valuation process similar to processes transpiring in face-to-face transactions. The market acts as an unpaid agent, relaying to the investor that based on all the information available to it, the value of the stock is the market price. The court also noted various empirical studies and law review articles extolling the virtues of ECMH.

In sum, Basic affirms that a plaintiff is entitled to a rebuttable presumption of reliance when he demonstrates that a fraudulent statement, omission or non-disclosure relating to a security traded in an “efficient” market: no personal reliance necessary. Moreover, since the 1970’s, the majority of corporate and securities law studies have used the ECMH as the basis to advocate their policies.

492. See id.
493. See id.
494. Id. at 244.
495. See id.
496. See id.
497. See id. at 247.
498. See id. ("[M]aterially misleading misstatements [must] have been disseminated into an impersonal, well-developed market for securities.").
V. ANALYSIS

A. Reg. FD Diminishes Analysts' Roles to the Detriment of Efficient Markets

For markets to be efficient, information about a company must be incorporated quickly and with great precision. Eugene Fama stated that well-informed and intelligent investors in an active market would fairly value securities reflecting all available public knowledge. The "well-informed" and "intelligent" investors Fama is referring to are market professionals such as financial analysts. Analysts perform two roles that lead to the formation of efficient markets: they produce and price information. "Production of information" involves searching for unknown information affecting prices. Such information includes information about the particular issuer as well as general market information. "Pricing of information" requires analysts to analyze the value of information which may lead to trading based on discrepancies between value and price. Analysts can use their information to either trade for their clients or give recommendations and advice to others. When analysts use their information in the form of recommendations or other reports, they contribute to an information market. The information market contains important benefits which improves the efficiency of the capital market. For example, every analyst who

500. See Gilson & Kraakman, supra note 462, at 574–79 (discussing the mechanisms by which information is disclosed).
503. Id.
504. Id.
505. Id.
506. Id.
508. Id.
discloses her research can be used as a foundation for research by other analysts, which assists them in improving their pricing.\textsuperscript{509} In addition, the information market leads to greater participation in the capital market. When analysts' reports are read by retail investors, they become more aware of financial events, which helps them build trust and confidence in the market.\textsuperscript{510} Confident investors are more likely to place trades, which leads to the demand of use of other analyst reports in the future and thus, lowers the cost of capital for firms.\textsuperscript{511}

The vague standard of materiality under Reg. FD makes it difficult for issuers to determine with certainty what constitutes immaterial disclosure.\textsuperscript{512} As a result, issuers tend to err on the side of caution by not providing earnings guidance or not speaking to analysts.\textsuperscript{513} The rule greatly hinders an analyst's ability to "ferret out" immaterial information from an issuer or question the integrity of the information provided. Because analysts are unable to ask questions and seek explanations, they are unable to "complete the mosaic," and thus, hinder their production of information function which is necessary for efficient markets.

Analysts' ability to "ferret out and analyze information" has been recognized by the Supreme Court.\textsuperscript{514} In Dirks, the Court found this function was "necessary to the presentation of a healthy market."\textsuperscript{515} The SEC itself has recognized the invaluable services of analysts. In the same case, the SEC in its brief stated, "[the] value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors."\textsuperscript{516}

Analysts ferret out information that, to the average investor, may seem inconsequential, but when supplemented with other information becomes highly informative and useful for investment decision-making. This process has been likened to putting together a jigsaw puzzle whose final picture is unknown but whose outline appears as new pieces are

\begin{thebibliography}{16}
\bibitem{509} Id.
\bibitem{510} Id.
\bibitem{511} See id. at 1264.
\bibitem{512} See, e.g., Arthur Zeikel letter, \textit{supra} note 56.
\bibitem{513} See, e.g., Hann's Statement, \textit{supra} note 414.
\bibitem{515} Id.
\bibitem{516} See \textit{Dirks}, 463 U.S. at 659 n. 17.
\end{thebibliography}
assembled. Because of analysts' experience, intuition, and education they are able "to see" the whole picture before less perceptive individuals including unsophisticated investors. The "production of information" tasks analysts perform include spotting and comparing inconsistent or contradictory public information with their own information they have gathered through observation and study. Analysts work like police detectives and are able to uncover clues about their target, i.e., company, which may lead to a more thorough investigation. Because analysts can "see the big picture" as a result of their investigations before other individuals, their research reports are an important source of information for investors. Analysts fulfill their "pricing of information" role by valuing the information they uncovered through their investigations and making necessary buy or sell recommendations. All market participants including other investment professionals such as "buy-side" analysts, institutional and professional traders, and retail investors benefit by using analysts' research and supplementing with their own experience and study to make better investment decisions.

Professor Daniel R. Fischel states that analysts also perform a monitoring function by checking the information provided by issuers whose management may disseminate false information or attempt to conceal negative information. In addition, analysts enable companies to disseminate information more cheaply as compared to public disclosure. Fischel notes that because analysts have a distinct advantage over lay investors in seeking and interpreting information, investors will utilize their recommendations to avoid needless expense. Most importantly, Fischel advocates that analysts and

517. See, e.g., Arthur Zeikel letter, supra note 56.
518. Buy-side analysts are "[a]n analyst employed by an entity, such as a mutual fund, that invests on its own accounts." Investorwords.com, at http://www.investorwords.com/cgi-bin/getword.cgi?656 (last visited Mar. 27, 2004) (noting buy-side analysts often purchase research from sell-side analysts for buy-side analysts' own use).
520. Id.
521. Id.
professional investors produce superior risk-adjusted portfolio returns for their clients. At first this may seem contrary to the ECMH which states that markets are so efficient that investors cannot earn superior returns. Fischel explains the paradox by noting studies that show that some information is not reflected in stock prices to ensure informed traders earn a competitive return for their diligence. Analysts usually follow a "top down" approach to analyzing particular companies. Analysts must be knowledgeable not only about their target company but also the environment in which they operate. First, analysts must be aware of the global economy and the intricate interdependence of economies of various nation-states. Second, analysts then examine the sector and industry of their target company. Only then do analysts examine the individual target company including its strategy, management, finances, and operating history. Analysts then use the information they have gathered to produce complex earnings forecasting models to value a company's stock. This estimated value is then compared to the stock's trading value and an appropriate buy/hold/sell decision is made. It is important to note that an analyst's model is only as good as the data and inputs that he receives. Good analysts do not try to find data that fit their model; good analysts develop a model that represents the data. And it is no wonder why analysts spend so much time and energy trying to find all available information.

Occasionally, the analyst as detective must question the company's management. With a skeptic's eye, an analyst asks penetrating questions that tests management's belief in its story. These conversations increase the amount of information available to the markets and supplement existing public information. Analysts need these conversations "because through these discussions analysts gain insight into a company's activities, ambiguity and uncertainty is reduced, and more understandable and relevant information will reach the market." In addition, analysts need one-on-one discussions "in order to fully understand the company's background and culture, to gain perspective about trends and developments."

523. Id.
524. Id.
525. Id.
Critics argue that it is impossible for analyst to speak with management without it disclosing material information. Nothing can be further from the truth. Reg. FD does not disallow one-on-one communications between an issuer and an analyst but only mandates public disclosure if material, nonpublic information is disclosed. If the SEC was convinced that issuers would always disclose material nonpublic information, it would disallow the communications altogether or promulgate heavier sanctions for such activities. One commentator shared his frustrations about convincing critics that private disclosure of non-material information is possible. Louis Thompson, President of the National Investor Relations Institute, notes that many of the SEC attorneys who draft the securities laws have no real world experience from the time they graduate from law school.\textsuperscript{526} Thompson expressed frustration where he brought several investment relation officers in front of SEC staffers to discuss how company officials could engage in one-on-one conversations with analysts without disclosing material, nonpublic information.\textsuperscript{527} Thompson lamented that after reading the staffers' body language, he knew they just did not "get it."\textsuperscript{528} Thomson's fears were realized when the SEC in its Adopting Release stated one-on-ones would be under heightened scrutiny for materiality determinations.\textsuperscript{529}

Some critics argue that analysts can receive all the information they need without talking to management. This is incorrect. Allow me to demonstrate with a short story that may be known to some readers.\textsuperscript{530} A professor assigned a research project to his students, and he asked them to write about all they could learn about fish. Later, the students finished their reports and were eager to discuss their findings with the professor. One student boasted that he spent many hours in a library perusing research periodicals about fish. Another student countered by exclaiming that he rented several videotapes about fish. A third student

\textsuperscript{527.} Id.
\textsuperscript{528.} Id.
\textsuperscript{529.} Id.
\textsuperscript{530.} The author does not recall the book or the author of the story.
exulted that he spoke with his uncle who researched fish. The professor sadly shook his head. He was sorely disappointed. He told his young students that if they wanted to learn all about fish, they must examine fish first hand. He told them that no research compares to actual experience.

The same can be said about analysts. Analysts can read all about a particular company until they are sick to their stomachs. Analysts can also watch all the public television announcements as well. But analysts may not truly know what all this information means until they had a chance to put it all in perspective by talking to a corporate executive and experiencing first hand what the company has to say. This experience is similar to Professor Sean McGuire’s admonition to genius Will Hunting in the movie, “Good Will Hunting”, where McGuire rebukes Hunting where when asked about love Hunting may be able to recite Shakespearean sonnets, but he would never know love until he “looked at a woman and became totally vulnerable.”

So, too, analysts may “know” much about a company but will not get the whole experience unless they converse with management.

There is much more information that is discussed in one-on-one meetings besides earnings. Topics sometimes include strategy, company history, corporate mission and goals, management’s philosophy, and competitive advantages and disadvantages. One survey found that four of the top seven drivers of stock value are non-financial. Another survey discovered that institutional investors place great importance on non-financial measures and intangible assets. The materiality of non-financial measures such as human capital and employee loyalty is

531. This quote is taken from the 1997 movie, Good Will Hunting.
533. Id.
534. Id. (“Studies by Ernst & Young and PricewaterhouseCoopers demonstrate that the institutional investors place significant importance on non-financial measures and intangible assets.”).
arguably less than earnings guidance; therefore, there are subject matters that management should be able to discuss with analysts.

Private contacts between companies and analysts contribute to marketplace efficiency. Corporate executives may be more willing to disclose information if they do so privately, rather than publicly. Management may talk more candidly because they are dealing with sophisticated experts who are comfortable with talking about hyper-technical and esoteric information. Analysts use these data inputs in their models the results of which are published through analysts' reports. The market benefits from the use of this new information. I accept the notion that there are great disparities in business savviness between lay and professional investors. Some stock market players hit home runs, while others, such as myself, watch from the stands. In fact, many investors recognize the utility of stock market giants as evidenced by the number of investors and amount of money parked in mutual funds. At the end of 2001, more than 93 million people invested six point nine trillion dollars into mutual funds. This dollar amount shows that investors recognize the value of investment professionals such as portfolio managers and analysts.

In sum, the market as a whole is damaged when issuers fail to communicate one-on-one with analysts. If issuers decide to disseminate information to the public at once, thus bypassing analysts, markets react inefficiently. Untrained, inexperienced investors do not have the requisite skill, experience, or knowledge to assess information accurately as provided to them. The purchasing and selling of stocks by irrational investors leads to a failure of the ECMH, as the stock price no longer reflects the value of all available information. Rather, the stock price reflects the value determined by irrational investors.

535. At first glance this statement may run counter to the notion that under efficient markets superior returns are highly unlikely. The author notes that ECMH assumes many intelligent market participants. However, not all market participants are equally intelligent. The author believes that in a very large market with many participants, there exist some individuals who possess an uncanny ability to assess the worth of particular information (pricing of information function) and allows them to make more informed investment decisions.


537. Id.
B. Selective Disclosure Leads to More Efficient Markets.

The SEC and many proponents of Reg. FD argue that one-on-one meetings between issuers and analysts resulted in nothing more than selective disclosure that inures to the benefit of the analysts’ clients or employer. In other words, Reg. FD advocates contend issuers provide analysts with inside information in return for analysts furnishing favorable reports. The author notes that little empirical evidence exists to establish that this alleged practice was the rule rather than the exception. In fact, the SEC conducted no factual study on the alleged pervasiveness of selective disclosure and only cited anecdotal evidence of selective disclosure in its final rule release.\textsuperscript{538}

Even assuming, arguendo, that selective disclosure occurred in meetings between companies and analysts through a wink or nod or overt and intentional declarations, selective disclosure is not necessarily a bad thing. Allowing analysts to derive private benefit from inside information ensures that the new information will reach the market rapidly in which share prices adjust quickly to reflect the new information, thus leading to efficient markets. When analysts have more data inputs, albeit nonpublic, material information, their economic models will more accurately reflect the intrinsic value of a company’s shares. Based on the differences between stock intrinsic value and stock market price, investor trading will take place and lead to a more accurate stock price. When share prices more accurately reflect available knowledge about companies, economic efficiency is enhanced.

Selective disclosure is not insider trading. Although the SEC believes that both insider trading and selective disclosure harm the integrity of the market because market participants lose confidence in a market dominated by insiders with superior information,\textsuperscript{539} the SEC fails to account for the Supreme Court’s decision in \textit{Dirks}. There, the Court found illegal only use of selectively disclosed information for personal advantage.\textsuperscript{540} This distinction is important because the Court recognized that selectively disclosed information that is not used for one’s personal benefit is “necessary to the presentation of a healthy market.”\textsuperscript{541}

\textsuperscript{538} See General Rule, \textit{supra} note 13.
\textsuperscript{539} \textit{Id.}, at 51,716.
\textsuperscript{541} \textit{Id.} at 658.
Selective disclosure and insider trading are different violations under the Exchange Act of 1934. Insider trading is a violation of Section 10b and Rule 10b-5 thereunder (anti-fraud provision), whereas selective disclosure is a violation of Reg. FD. Selectively disclosed information is used for analysts' research and production of information whereas insider trading's purpose is for "manipulation or deception" for personal gain. Analysts simply cannot be liable under Rule 10b-5 unless the information they disseminated was used to willfully defraud.

Despite the distinctions enumerated above, the SEC and other Reg. FD proponents' position is to treat selective disclosure and insider trading similarly. For example, the SEC in its Reg. FD final release stated "a close resemblance" between selective disclosure and insider trading existed. The SEC also delineated similar adverse impacts on market integrity and economic effects. In addition, an often overlooked fact in the release is where the SEC took the opportunity, sua sponte, to change existing insider trading laws by modifying Rule 10b5-1 and Rule 10b5-2. For purposes of argument, I assumed that

542. Id. at 651,716.
543. Id. at 663.
544. Id.
545. See at 667 n. 27.
546. See Insider Trading, supra note 196. ("Issuer selective disclosure bears a close resemblance in this regard to ordinary 'tipping' and insider trading. In both cases, a privileged few gain an informational edge—and the ability to use that edge to profit—from their superior access to corporate insiders, rather than from their skill, acumen, or diligence.").
547. Id.

Likewise, selective disclosure has an adverse impact on market integrity that is similar to the adverse impact from illegal insider trading: investors lose confidence in the fairness of the markets when they know that other participants may exploit 'unverifiable informational advantages' derived not from hard work or insight, but from their access to corporate insiders. The economic effects of the two practices are essentially the same.

548. Id. at 17 C.F.R. § 240 (2004). The rule now defines "on the basis of" to mean awareness of material nonpublic information. A trade is on the basis of material nonpublic information if the trader was aware of the material, nonpublic information when the person made the purchase or sale. The SEC stated the awareness standard reflects the common sense notion that a trader who is aware of inside information when making a decision inevitably makes use of the information.
549. Id. at 17 C.F.R. § 240 (2004). The rule now sets forth a non-exclusive list of three situations in which a person has a duty of trust or confidence for purposes of the
the two actions are similar but prove that selective disclosures of material, inside information will lead to more efficient capital markets because share prices will reflect all information: both public and private. Presumably, inside information will be disclosed publicly at some time in the future. If this was not the case, insiders would have no incentive to trade on inside information. Insiders with nonpublic information will bid up or down the prices of stocks in anticipation of the public release of information. The result is the stock price will more fully reflect all information about a company at any point in time.

C. Small Firms Receive Analyst Coverage by Lowering Analysts' Cost of Production of Information

We have already discussed how analysts are important for many companies, especially small ones, whose existence is not well-known to the market. For a variety of reasons, many companies do not attract analysts’ attention. For lesser known companies, the costs to some analysts to fulfill their production of information role are substantially higher than any return they may realize to justify their coverage. The problem is magnified if the analyst is the first to initiate coverage because of the huge resources expended to begin research. Costs are lower for other analysts to follow because they can “piggy back” on the research conducted by the first analyst. Because few analysts are willing to expend the money and take the risk of initiating coverage of a company, the capital market is hurt where investors are unknowledgeable about another possible investment opportunity. Likewise, the company is hurt because its shares are infrequently traded.

“misappropriation” theory of the Exchange Act and Rule 10b-5 thereunder. A duty of trust or confidence exists: (1) whenever a person agrees to maintain information in confidence; (2) when two people have a history, pattern, or practice of sharing confidences such that the recipient knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; (3) when a person receives or obtains material nonpublic information from certain enumerated family members: spouses, parents, children, and siblings. Id. The rule was expected to address the anomalous result under case law where a family member who trades in breach of a reasonable expectation of confidentiality does not violate Rule 10b-5 but would violate that rule if the family member received a tip and then traded or traded in breach of an express promise of confidentiality. Id.
which leads to decreased liquidity. Efficiency in markets with smaller companies is decreased.

Small companies can rectify this situation by enticing analysts to follow the companies' stock by offering selective disclosures. Analysts who receive this information will save money by not expending as much resources on research. This lowers the costs to analysts which makes coverage of small companies more likely. The analysts may also benefit by receiving a higher than competitive rate of return on their investments through selective disclosure and subsequent trading by its firm. The higher returns compensate the analyst for the increased risk she assumes from initiating coverage. In addition, the analyst receives sensitive information in which she uses to update her earnings models and issues reports which are read by market participants. New information travels in the market and is reflected in more accurate share prices of the target company. Efficiency in the markets with smaller companies is thus increased.

D. Other Critics on Ban on Insider Trading and Selective Disclosure

Some critics on the ban on insider trading suggest that shareholders and managers should be permitted to contract over the allocation of property rights in inside information. These critics posit that privately negotiated agreements will allocate resources to their most valuable use. Professors Frank Easterbrook and Daniel Fischel argue that insider trading is a good form of compensation. For example, they declare that when a manager sees a good investment for the firm such as a possible merger, the manager will be more inclined to pursue the merger if she is rewarded on success. Professor Jonathan Macey

550. Professors Zohar Goshen and Gideon Parchomovsky agree. They state: "Yet, for small companies whose shares are traded with low liquidity, it is a necessary step on the way to competitive analyst coverage. In this sense, the exclusivity generated by selective disclosure is analogous to that created by patent or copyright protection." Goshen & Parchomovsky, supra note 502, at 1269.


554. Id.
articulates that allowing insider trading will enable corporate managers to reduce their salary demands equal to the expected gain from insider trading. Shareholders benefit by paying lower salaries to managers. Professor Henry Manne declares that allowing managers to trade on inside information creates incentives to produce valuable information that inures to the benefit of shareholders by increasing the value of the firm.

E. Insider Trading Properly Motivates Management

I agree with Professors Easterbrook and Fischel who argue that insider trading adequately compensates managers and motivates them to work in the interest of the company and its shareholders. For insider trading to be profitable, stock prices must move. Management will do everything in its power to seek profitable projects, lower costs, and so on to increase share price. If management is successful, they are rewarded and the firm's shareholders benefit from a higher share price.

Of course one can argue that management can engage in nefarious practices that would lead to a stock price decline. Managers who short sale their stock would benefit to the detriment of long shareholders. Companies can easily remedy this possibility by contracting with managers to disallow short sales. Moreover, the likelihood of this scenario occurring is poor. Managers do not work in isolation and are accountable to higher ups. In addition, managers often direct the work of people below them. The people with whom the managers interact are likely to spot and report any suspicious activity to the responsible parties. Unless a conspiracy is involved, managers cannot get away with corporate sabotage.

Increased share price accuracy due to selective disclosure will limit the extent to which managers place their own interests above the corporation. For example, the threat of hostile takeovers increases when

556. Id.
558. Even with the highly publicized fallouts of corporate executives at Enron, Tyco, and Adelphia, corporate conspiracies of these magnitudes happen relatively infrequently.
managers engage in actions that do not maximize shareholder value. The threat of takeovers increases because takeovers are less risky for potential acquirers and target companies have a lesser chance of deterring a takeover with an inaccurately high share price.\textsuperscript{559} In addition, Professor Merritt Fox posits that when risks associated with holding an issuer’s stock in a non-diversified portfolio is lessened, the use of share price based management compensations is increased because of increased share price accuracy, which aligns the interests of management and shareholders.\textsuperscript{560}

\textit{F. Selective Disclosure Is Fair: Outsiders Are Neither Hurt nor Helped by Insider Trading}

The SEC has consistently disparaged the use of selective disclosure and insider trading. The SEC believes that the practices harm the integrity of the market because the investing public loses confidence in a market when they perceive the market is controlled by investors who have access to superior information. In other words, selective disclosure leads to a loss of investor confidence in the integrity and fairness of capital markets.

I note that economics is concerned with efficiency and not fairness. Fairness is a policy matter better left for discussion among politicians and philosophers. However, because the SEC cited fairness as one of its reasons for justifying the need for Reg. FD\textsuperscript{561}, a proper discussion is not irrelevant. I will attempt to prove that although selective disclosure may lead to a transfer of wealth, this practice is not unfair.

Allow me to propose an overly simplistic hypothetical. Suppose a stock sells for $10 but an analyst believes the stock will soon trade upwards to $15. If the analyst’s clients purchase the stock based on selectively disclosed information received by the analyst, the stock price will move towards $15. Presumably, the stock price will reach $15 sooner than it otherwise would have. Because the stock price approaches $15 (and all prices between $10 and $15) sooner than it would have, insider trading makes the market more efficient because the


\textsuperscript{560} \textit{Id.} at 2458–50.

\textsuperscript{561} \textit{See Selective Disclosure, supra} note 39.
$15 price reflects all available information including nonpublic information.

Some critics of selective disclosure and insider trading argue that because a company has a fixed number of outstanding shares, for each share purchased by one of the analyst's clients on the basis of the analyst's advice (due to the selective disclosure) leaves one less share held by an outsider who did not receive the analyst's advice. In the long run, the analyst's clients' gains would equal the losses to the outsiders. Clients benefit at the expense of outsiders. This transfer of wealth is seen as unfair to critics of insider trading despite any increases in market efficiencies.

Critics' fairness argument is unpersuasive because they are focusing on the wrong period of time. The appropriate period of time to analyze fairness should be at the outset when investors decide whether or not to buy the stock. At the outset, investors decide whether the risks in the stock justify the market price. If not, investors forego the purchase. One of the hundreds of risks affecting market price and return is insider trading and selective disclosure. Insider trading occurs in U.S. capital markets.\textsuperscript{562} If the buyer bets that the current market price adequately reflects the risk of insider trading (\textit{i.e.}, bought at a discount) and selective disclosure subsequently occurs to her detriment, she cannot complain. At the outset, the buyer took a chance that insider trading would occur, and she paid a lower price on the stock to reflect that risk. In effect, she lost her wager. Critics may argue the investor was unaware of the risk of insider trading. This may be true but the investor is probably unaware of other risks as well such as currency rate exchange, interest rates, production bottlenecks, etc. If the investor accepts the rewards of a stock gain, she must accept all the underlying risks, known and unknown.

Lay investors trade stocks for a variety of reasons. Some choose particular stocks based on fundamentals, others choose based on whim.

Many investors purchase stocks for retirement and savings purposes and sell stocks to meet future expenses or emergencies. These investors maintain a buy-and-hold strategy and hold stocks for the long-term. Hence, these investors do not try to "beat the market" by trading frequently. Suppose selective disclosure and concomitant trading by an analyst's clients occurs which "bids up" the price of a particular stock. Suppose further the buy-and-hold investor purchases this artificially inflated stock. Arguably, this investor has "lost" money because she purchased a stock at a higher price than would have been purchased had the selective disclosure and trading not occurred. Suppose however, that it becomes time for the investor to sell. Because the stock price is artificially higher than it would be absent insider trading, the investor has "gained" money due to the selective disclosure. Because the investors loses and gains more with the presence of selective disclosure, the net effect is that selective disclosure cancels both the gains and losses to the investor. In sum, over the investors' lifetimes, they break even.

In another example, suppose an investor is willing to pay the current market price, $10, for a stock. Suppose further that an "insider," such as an analyst, has knowledge of an impending, negative news announcement. At the same time, the insider short sells the stock. If the announcement is made, the stock price falls to $5. The buyer loses $5 while the short seller gains $5. In this example, the insider is not the cause of the buyer's loss because the buyer decided to purchase the stock at the outset. In fact, the insider can argue that his short selling resulted in a lower purchase price for the buyer such that the buyer can "average down" his loss. The buyer may counter by arguing that insiders have an incentive to delay disclosing their inside information so as to maximize their profit potential from the market's ignorance to the detriment of outsiders. I believe the analyst can successfully rebut this argument by explaining that analysts and other insiders are in competition with themselves, and if one analyst waits too long to trade, another analyst may trade before her. Thus, the information is divulged to the market and the second analyst loses her superior information advantage. To conclude, analysts will be motivated to disclose their information as quickly as possible so as to not lose their trading opportunity to other insiders. Analysts with selectively disclosed information, driven by their self-interest and competition by other analysts will hurry to be the first to trade until the "correct" stock price
is reached. I realize that some smaller companies may have only one analyst covering them where the analyst holds a monopoly on the inside information. If this is so, outsiders have a valid reason to argue. However, for small companies this exclusivity may be a necessary step on the way to wider analyst coverage.

Investors are able to protect themselves from the perceived risks of insider trading. Insider trading is a company specific risk that can be diversified away by carrying a large basket of stocks. Critics may argue that not all investors are able to afford purchasing several stocks to establish a diversified portfolio. Although this is true, investors are able to purchase mutual funds which give investors instant diversification. Some mutual funds can be purchased for as little as $500 which is a relatively small enough dollar amount to attract investors.

Selective disclosure may appear unfair especially to outsiders who must compete with insiders. Portfolio managers of active funds (and lay investors) may find it increasingly difficult to make above average returns in markets made more efficient by selective disclosure and concomitant trading by analysts. However, this in itself does not imply selective disclosure is malicious. Although portfolio managers and other outsiders may arguably be harmed, their interests are incongruent with the interests of the market and the economy. The economy as a whole gains by more efficient pricing of stocks. Even if outsiders might suffer harm, the beneficial effects to the market and economy greatly outweigh the harm to a select few. Critics may argue that investors will not invest in a market they deem is unfair which, in the aggregate, would harm the entire market. I agree that many investors may decide to keep their money stashed under their bed mattresses. But despite the numerous news articles about insider trading in the United States, there is no

---

563. Zvi Bodie et al., Investments 350 (5th ed. 2002) (stating firm specific risk can be eliminated through diversification).
565. Id.
evidence that insider trading has discouraged a significant number of investors from participating in the stock market.

If selective disclosure is allowed, not only will capital markets become more efficient, but there may no longer be a need for SEC’s oversight of mandatory disclosures. The SEC since time immemorial has advocated the need for disclosure and transparency. Former SEC Chairman Arthur Levitt has championed increased disclosure since his tenure began in 1993.\textsuperscript{567} Levitt established a free SEC website\textsuperscript{568} that features corporate filings and other valuable information as well as Reg. FD which is the subject of this Article. If selective disclosure is allowed, there will be no delays or uncertainties about what has to be disclosed. There will be no issues about when and in what form information must be disclosed. Companies, through the trading of its analysts, will effectively disclose to the market information which will be reflected in increased share price accuracy. Investors will receive important information in the form of accurate share pricing. There may no longer be a need to regulate broker-dealers, investment advisers, analysts, etc. New information will be evaluated efficiently through a market-driven process without the excessive entanglement of government.

CONCLUSION

Regulation FD represents a noble attempt by the SEC to restore a balance of power between lay investors and professionals such as investment analysts. Although the SEC attempted to alleviate a problem perceived as unjust, the problem was more apparent than real. The SEC only cited news articles as evidence of this alleged ubiquitous practice. The SEC, without the benefit of a proper cost-benefit analysis, has created new law whose over-inclusiveness has burdened the great majority of public companies who are good corporate citizens. Despite former Commissioner Unger’s and the industry’s concerns about Reg. FD including the chilling of corporate disclosures, lack of better

\textsuperscript{567} F.T. McCarthy, Shining Light on the Markets: Arthur Levitt’s Chairmanship of the Securities Exchange Commission May Be Ending with a Fight over One of the Most Fundamental Issues in American Capitalism: Who Should Be in the Know, ECONOMIST, Oct. 28, 2000, at 71 (stating increased disclosure was Levitt’s highest priority).

\textsuperscript{568} See http://www.sec.gov.
materiality standards, and others, the SEC made only modest revisions to Reg. FD more likely to appease rather than to quell their fears. The three SEC enforcement actions against Secure, Raytheon, and Siebel highlighted the SEC's unwillingness to further provide guidance on materiality and instead relied on after-the-fact evidence of materiality such as stock volume and price changes. Reg. FD has only contributed to the confusion among issuers as to how to comply with the rule and avoid enforcement actions. Instead of providing clear guidance on what actions are prohibited, the regulation has increased uncertainty in an already uncertain marketplace.

The push for increased disclosure is not having the effect the envisioned by the Commission. Although there is some evidence that the number of corporate disclosures has not been “chilled,” these studies only analyzed earnings forecasts and not other forms of disclosures such as webcasts, one-on-one telephonic meetings with analysts, Form 8-K’s, and others. In addition, these studies have not analyzed the quality of information which many analysts and market professionals argue have been diminished. Other studies proved Reg. FD’s opponents’ criticisms were justified. Stock volatility has increased after Reg. FD and the accuracy of analysts’ earnings forecasts has declined dramatically. The SEC should re-evaluate Reg. FD in light of these recent findings.

Although Reg. FD may have “leveled the playing field” to the delight of lay investors, the SEC has done so at great costs. Private contacts between issuers and investors lead to more efficient markets which redounds to the benefit of all investors through the efficient allocation of economic resources. If Reg. FD curtails the use of selective disclosure, but in so doing makes all investors less knowledgeable about the company, it will not create fairer, more efficient markets. Reg. FD has brought inefficiency to the market by dissuading issuers from communicating one-on-one with analysts; in its place, issuers are disclosing information to the public at once. Untrained, inexperienced investors do not have the requisite experience, skill, or knowledge to assess this information accurately when formulating investment decisions leading to a failure of efficient capital markets. Instead of stock prices reflecting the informed buying and selling by rational investors, the prices reflect market actions by irrational investors as they work feverishly to decipher corporate disclosures.
Even if selective disclosure occurred frequently in the market, this practice leads to more efficient markets. When analysts receive new information from companies and trading by analysts’ clients occurs, this new information will reach the market in the form of updated share prices which adjusted quickly to reflect the new information, thus leading to efficient markets. Stock prices more accurately reflect their intrinsic value if trading occurs with the knowledge of both public and private information. Market efficiency is not the only benefit of selective disclosure. Small, lesser known companies can attract analyst coverage of their stock by offering selective disclosures. The trading profits from selective disclosures will help offset the increased risk the analyst assumes from initiating coverage.

Despite the SEC’s and lay investors’ criticisms, selective disclosure is fair. When an investor chooses whether to purchase a particular stock, she must decide whether the current market price is greater than the risks reflected in that stock. One of several risks inherent in stock markets is selective disclosure. This risk is "priced in" and appropriately discounted in the current market price. If the investor purchases this stock whose price in the future ultimately falls because of selective disclosure, the investor cannot complain because she bought the stock at a discount and thus, lost her wager. Further, if the stock price went up because of selective disclosure, the investor gained through no action of her own. In the long run, the investor’s net position is offset by these two possible alternatives.

Reg. FD’s effect may be more symbolic than real. The SEC responded to a practice perceived by the public to be unfair and unjust. The SEC, in haste, promulgated new regulatory obligations on issuers without contemplating the costs and burdens associated with such a rule. In the end, the SEC made a policy decision and weighed fairness over efficiency. Investors have received little benefits from the regulation and many more disadvantages. The SEC has fairly disrupted a system by entangling itself in a market which has, for many years, shown that its industry professionals know best how to operate.