

## **TO SPEAK OR NOT TO SPEAK: THE UNTOLD STORY OF FAIR DISCLOSURE**

*By Robert D. Ferris & Lev Janashvili*

If Arthur Levitt had to write the history of capital markets, he would probably divide the subject into the Dark Ages and the Renaissance. The two eras would be set apart by a watershed event – the adoption, circa 2000, of Regulation FD (Fair Disclosure). Reg FD, as the rule has come to be known, was Levitt’s cherished brainchild, another opportunity to lay down an enduring and positive legacy.

In hindsight, though, the rule has arguably proven more divisive and confusing, and on a broader scale, than any other regulatory action by Levitt or his predecessors. Reactions to Reg FD have tended toward self-serving extremes: avid advocacy from the rule’s beneficiaries -- mainly the media -- and single-minded opposition from the rule’s casualties -- mainly the securities industry.

Advocates of Reg FD see it as an overdue and effective assault on the menace of “selective disclosure,” which Levitt once decried as “a stain on the market.” Essentially, what got the Chairman riled up is that, in the Dark Ages - before Reg FD - access to important corporate information (e.g., earnings forecasts or “guidance”) was not a right that all investors enjoyed; it was rather a privilege that grew in proportion to the number of shares an investor owned or the amount of influence he exerted in other ways.

As a result, large institutional investors and prominent financial analysts enjoyed front-row seating in the theater of corporate disclosure; they were close enough to detect the winks, whispers, nods and innuendo, subtleties of body language as well as utterances blatantly intended only for front-row spectators. By contrast, most retail investors and the media, seated far back (if they happened to be in the theater at all), could only see the token gestures and hear the tongue-in-cheek monologues that the better-situated elites knew not to take seriously. Second-class spectators had no choice but to savor the boilerplate, cheery prose of news releases or the dense legalese of SEC filings. As a result of this class-based disclosure, well-heeled observers were much better equipped to invest profitably; they knew when to step in and when to exit. Retail investors usually relished these nuggets of wisdom in hindsight. And the media couldn’t help them much either.

Levitt’s effort to bridge this informational chasm should have been supported by all, one would think. Full and fair disclosure of corporate information – to everybody at the same time – simply levels the playing field for all investors. And it conforms to the spirit of the Securities Exchange Act of 1934. If a company is holding a conference call to discuss a recent earnings release, why not grant everyone access? If the CEO is presenting at a brokerage conference, why not webcast the presentation to provide for a broader dissemination of the message?

So if the goal of Reg FD is so noble and the means so harmless, why is Wall Street up in arms? Does anyone really want to prolong the sweeping incapacitation of the vast majority of investors?

No, claims the Street's party line; it maintains, rather, that instead of cultivating a more broadly informed market place, the regulation's punitive provisions might spook companies into a minimalist approach to communications. And that doesn't serve any investor's interest. Further, corporate America's reticence will increase stock volatility because analysts' predictions of future performance will become more fallible. Thus, Levitt's high-minded attempt to safeguard shareholder equality has yielded unintended and ironic consequences: It has discouraged – if not put a lid on -- proactive, forward-looking communications and, therefore, hurt all investors – well, in equal measure just to be fair.

Whether these stark, black-and-white depictions come from Reg FD's supporters or detractors, they invariably miss the subtler story. Reg FD is not good or bad. It is rather an attempt at a solution. As such, the rule is as well intended as it is misguided and inconsistent. Unfortunately, empty challenges dominated much of Reg FD's media coverage at the expense of legitimate concerns. As a result, not only did the rule pass, it did so without shedding most of its truly objectionable elements.

Consider the empty challenges first:

#### The Chilling Effect?

When the proposal for Reg FD was first introduced in August 2000, the brokerage community complained that the rule would inhibit, if not eliminate, the spirited, visionary discourse they often shared with senior corporate managers. The translation of this complaint is: “management will no longer spoon feed us the material, non-public information that makes us sound so smart when we present it in the guise of original research.” Of course, this is precisely the kind of interchange that Reg FD was designed to obstruct, and the rule's success in this area is no unintended consequence. It certainly does not hurt all investors, but only the privileged few who would like to continue enjoying these revelations in violation of existing insider-trading restrictions.

Of course, it's easy to understand why some companies may treat Reg FD, just as most new regulations, with a measure of caution. Many of the rule's implications have yet to be understood. Its ambiguous language has yet to be molded -- through experience and interpretive court rulings -- into more-or-less concrete directives. The punitive measures pose yet another risk for corporate managers -- many of them already battle-scarred by the threat or experience of past shareholder class actions. The rule's tone seems mostly restrictive, rather than affirmative. Thus, many American corporations, fixated on the legal liabilities the rule has produced, maintain a defensive posture, even months after Reg FD took effect.

A recent NIRI (National Investor Relations Institute) survey shows that, while 75 percent of companies release about the same amount of information as before or more, 24 percent of NIRI members now provide less information.

But in the final analysis, nothing in the letter or spirit of Reg FD discourages good old corporate story telling (of course, the kind that does not venture beyond the truth); the rule simply insists that no investor be excluded from the audience. So, the newly reticent companies (the 24%) might be missing this simple point.

Companies inclined to engage the investment community in dynamic, unencumbered dialog can feel free to do so, after Reg FD just as before. What they cannot do now is much the same as what they could not do since 1934 – dish out material corporate information in exchange for the graces of Wall Street’s *uber*-class.

### Oh, the Scourge of Volatility

Let’s make this really simple. Imagine a student who got a near-perfect score on a test not because he had studied, but because he had received all the answers before the test in a convenient crib sheet. Is it likely that this student’s score will go down significantly if the teacher deprives him of his crib-sheet privileges? Even if the answer is yes, can we blame the teacher?

Similarly, if analysts’ earnings estimates become less accurate under Reg FD, is it because Reg FD stripped them of their accuracy? Or is it because their estimates never had anything but an illusion of accuracy? Management told analysts what to write. They wrote it.<sup>1</sup> Now that the SEC has seized on the importance of equal access to information, analysts are losing their edge. It seems that Reg FD has chipped away not so much at analytical accuracy, but rather at the tired pretense of analytical rigor.

### The Real Weaknesses: Inconsistency, Vagueness

The securities industry may be justified in seeing Reg FD as a threat. Most public companies probably cannot help but see the rule as a nuisance, to say the least. For both these groups, the regulation has disrupted a comfortable status quo. The media, on the other hand, have to see the rule as nothing short of a bonanza. Reg FD exempts “bona fide news organizations” from restrictions. While companies cannot disclose selectively to investment professionals, the media are fair play. The text is explicit on this point: “Regulation FD will not apply to a variety of legitimate, ordinary-course business communications or to disclosures to the media.”

No doubt, the exemption is a big – and surprising - win for the media; yet, how is this discrimination justified?! The media continue to enjoy legitimate access to material, non-public information, which now becomes much more newsworthy because other market movers (investors, financial analysts) have been jettisoned from the elite circle of trust. Whether public companies like this change or not, the road to the minds and hearts of investors increasingly passes through the critical prism of the media, rather than the

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<sup>1</sup> However you may be inclined to describe this process, it is actually called “guidance.” Clearly, “parroting” or “highly paid stenography” didn’t quite capture the dynamic complexity of the interchange.

ineffectual advertorial of sell-side research. And this, the media would probably argue, is good news.

With their interests served so handsomely by Reg FD, most journalists have resisted the impulse to point out the absurdity of the media's exclusion from the rule's scope. The ruling suggests that, because the media regularly publish the information they receive from companies, selective disclosure to a bona fide media outlet actually reaches all of its readers – the investing public. Hence, the disclosure is not selective at all.

By the same token, sell-side analysts regularly publish, for their retail and institutional clients, the information they receive from companies. So, shouldn't sell-side analysts receive the same preferential treatment as the media? One of the reasons the answer is "no" is that the analyst is under no obligation to share the wisdom – just as a journalist doesn't have to publish what he learns in a one-on-one interview with a CEO. Having said that, both the analyst and the journalist can simply trade on the information. Now, that is wrong!

Another reason sell-side analysts are not a means of full and fair disclosure is that their audiences (clients) may be quite limited. But many news media, too, have only amassed puny audiences, and corporate news don't reach much further through these outlets than they do through sell-side "research." Then isn't there a need for some guidance on what constitutes a media outlet in the context of Reg FD?

Apparently, not. And this confusion adds to the absurdity of the media's exclusion from Reg FD. Consider a CEO who receives a request for material information. Should he comply whether the request comes from *The New York Times* or *The Hartford Courant*? How about the *Dallas Observer* or *New York Press*? Or, a local newspaper with a circulation of only about 20,000? Is any publication too small to enjoy the same exemption as the *Wall Street Journal*? On this, Reg FD is silent. But the rule does warn quite clearly that, if the same request comes from an investment professional, the CEO cannot comment, even if he is dealing with a sell-side analyst whose audience easily eclipses the local paper's 20,000 readers.

But even prominent media such as *Dow Jones News Wire* or *Bloomberg News* raise similar concerns about exclusivity. Neither one of these news feeds is available to most retail investors. They are only accessible through costly news databases such as Dow Jones Interactive, Lexis Nexus or the Bloomberg terminal.\* No investor can retrieve Dow Jones news on a company from *Yahoo! Finance* or *MSN.com*.

So, back to the CEO's dilemma. If our CEO receives a request for material, non-public information from Dow Jones, he may well comply, citing the exemption of media from Reg FD. However, it is highly unlikely that most of his retail shareholders will see the story that follows the interview. Thus, even meticulous compliance with Reg FD may help disenfranchise the very investors the rule was introduced to protect.

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\* Bloomberg does provide a very limited newsfeed on its web site.

## Why Punish the Perpetrator, Why Not the Mastermind?

If some shareholders have indeed been disenfranchised by selective disclosure in the past, was Levitt right in placing the onus of corrective action on public companies, rather than the securities industry? True, corporate officers usually decide what information is disseminated, and in what way; they are the ones who may decide to engage in mutual palm-greasing with preferred analysts: “I give you the information. You write what I tell you to write.”

But corporate officers -- especially at small, orphaned companies -- usually resort to this strategy not by choice but by necessity. How else can they enlist the support of a brokerage firm? How else can they draw the attention of Wall Street analysts and CorpFin directors? Granted, such tactics violate the law. But shouldn't some of the blame transfer to the brokerage firms, which, increasingly, only agree to “recommend” (Wink! Wink!) companies either in exchange for investment banking business or privileged access to information.

## Looking Ahead

Levitt recently announced his resignation, and a Republican Acting Chairperson has been appointed at the SEC. Together with the newly elected Republican President, these developments make the long-term survival of Reg FD far from certain, at least in its present form. Whether the regulation is upheld, repealed or modified, the questions it tackled will continue to gnaw at regulators, Wall Street and Corporate America. What information can public companies disclose? At what time? To whom? How can we assure all investors, retail or institutional, equal access to corporate information? Does sell-side research have a reason to exist at all?

As is common with hotly debated issues, the rhetoric around Reg FD has become polarized around simple issues that simply miss the point. The market has been dissecting the text of the rule and cataloging the liabilities spawned by the regulation. Companies have been revising their communications practices to reduce the risk of “legal exposure.”

While these tactics may help companies comply with disclosure requirements and avoid legal liability, they also distract corporate managers from a more important goal – building value. And to this end, the main challenge for public companies is not compliant disclosure but rather effective communications. Granted, a public company should know what to disclose, when and to whom. But ultimately, a more important question is how a public company can impart its business story to the market, cultivating broad-based understanding of its business model and economic landscape. How can a company deliver its perspective on its own performance and prospects<sup>2</sup>?

A thoroughly informed market place offers public companies several benefits: It allows them to speak freely without violating selective disclosure rules. And of course, it

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<sup>2</sup> Obviously, this is completely different from spoon-feeding earnings projections to handpicked analysts.

provides for market stability and fosters full and fair valuation. Ultimately, that's the objective of public companies. So, the chilling counsel of some lawyers notwithstanding, the intent of Reg FD is not to inspire legalistic hairsplitting. The rule is simply another incentive toward richer, more equitable disclosure.<sup>3</sup>

If fairness and common sense prevail in the end, we should see some changes both in Reg FD and in the dynamics of the financial community. The rule should shed its provisions for VIP treatment of the media. The media should learn, yet again, that they should report on newsworthy stories -- such as the inanity of Reg FD's treatment of the media -- even if these stories supplant media's narrow interests. Sell-side analysts should start doing real research, if they do it at all. And they should take a cue from the media, which have long distinguished -- albeit, with varying success -- between editorial content and advertising.

No doubt, Levitt is sincere in his belief that he has nudged the market toward greater fairness and efficiency. To a large extent, he's probably right. But until we see how and if these changes take place, it will be hard to say whether the market has actually entered its Renaissance.

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<sup>3</sup> In fact, Reg FD does not change the SEC's stance on selective disclosure as much as many companies assume. Companies that engaged in selective disclosure before Reg FD were violating at least the spirit of restrictions (10 b5) that have existed since 1934.