Regulation FD: Leveling the Playing Field for Some But Not for Others

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Law Summary

Regulation FD:¹
Leveling the Playing Field for Some
But Not for Others

I. INTRODUCTION

As regulator of capital markets in the United States, the rules and policies of the Securities and Exchange Commission ("SEC") structure incentives that affect the allocation of capital resources and determine economic growth.² Indeed, for the past eight years, the SEC energetically has been restructuring those incentives by expanding its role:³ the SEC has enervated its activities in some areas⁴ and forged new directions for itself in others.

One of those new directions is Regulation Fair Disclosure ("Regulation FD").⁵ Adopted on August 24, 2000, Regulation FD prohibits selective disclosure, or an issuer's release of material, nonpublic information regarding that issuer to individuals or groups of individuals (typically investment professionals)


³ This is due, in large part, to Arthur Levitt, Jr.'s role as Securities and Exchange Commission ("SEC") chairman. Chairman Levitt's eight-year tenure at the helm of the SEC has been among the most active of any chairman. See Michael Schroeder, Levitt Will End 8 Activist Years as SEC Chief Early in 2001, WALL ST. J., Dec. 21, 2000, at C1. Chairman Levitt stated: "Our nation faces no higher economic priority than to keep investors confident of the markets' integrity." Arthur Levitt, Jr., Investor Protection in the Age of Technology, at http://www.sec.gov/news/speech/speecharchive/1998/spch205.txt (last visited Apr. 5, 2001).


rather than generally releasing the information to the public. 6 Unfortunately, Regulation FD promises to impose costs upon corporations and investors that outweigh any fairness benefits the SEC hopes will accrue.

First, as a backdrop to Regulation FD, this Law Summary will review the SEC's vision of itself as the investor's protector. In so doing, this Law Summary considers the workings of the capital markets, the price of information, and the vital role of selective disclosure. Next, this Law Summary outlines the SEC's previous attempts to regulate selective disclosure. A presentation of Regulation FD follows with a focus on its more salient points for corporate counsel. Finally, this Law Summary concludes with a commentary that is generally skeptical of Regulation FD's actual results.

II. LEGAL BACKGROUND

A. The SEC and the Price of Information

The SEC was created by Congress to regulate the securities markets in the United States. 7 To do so, the SEC was empowered with rule-making and enforcement powers. 8 For the SEC, regulation of the markets has come to mean making capital markets fair for investors. 9

In its regulation of the markets and protection of the investor, the SEC has become an information regulator, dictating not only what information must (and

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8. 1 HAZEN, supra note 6, § 1.4, at 15.

9. SEC, supra note 7, at 3 ("The U.S. Securities and Exchange Commission's mission is to administer Federal securities laws that seek to provide protection for investors. The purpose of these laws is to ensure that the securities markets are fair and honest."). Excerpts from the legislative history suggest this goal is a congressional mandate: "The purpose of [the Securities Act of 1933] is to ... place the buyer [of a security] on the same plane so far as available information is concerned, with the seller. ... We want to protect the gullible investor, the investor who has been imposed upon. This is tremendously important." 77 CONG. REC. 2,918, 2,920 (1933).
must not) be released\textsuperscript{10} and what can be done with it,\textsuperscript{11} but when,\textsuperscript{12} to whom,\textsuperscript{13} and in what manner and form it must be disclosed.\textsuperscript{14} The SEC has declared openly that fairness, rather than efficiency, is its north star in guiding policy decisions.\textsuperscript{15}

For instance, the antifraud rules state the permissible uses of information. Such rules protect investors through the prevention of fraud and overreaching, primarily by deterring market manipulation and insider trading.\textsuperscript{16}

10. Section 7 of the Securities Act stipulates what information must be contained in an issuer’s registration statement. \textit{See} Securities Act of 1933 \textsection 7, 15 U.S.C. \textsection 77g (1994); \textit{see also} 1 HAZEN, \textit{supra} note 6, \textsection s 3.1-4, at 86-105 (covering the preparation and filing of the registration statement).

11. If a person receives inside information regarding a stock and knows or should have known that he or she received it in breach of a fiduciary duty, he or she must disclose the information or refrain from trading based upon that information. Dirks \textit{v.} SEC, 463 U.S. 646, 660 (1983); Chiarella \textit{v.} United States, 445 U.S. 222, 230 (1980). For an examination of this rule’s evolution, see \textit{infra} notes 112-33 and accompanying text.

12. Section 5 of the Securities Act governs what information a company can release during the phases of registration with the SEC. \textit{See} Securities Act of 1933 \textsection 5, 15 U.S.C. \textsection 77e (1994).

13. The registration requirements stipulate that an issuer must disclose certain information to the SEC. Furthermore, under \textsection 10(a), the investor must receive in the prospectus virtually all of the information that would be contained in the registration statement. \textit{See} Securities Act of 1933 \textsection 10(a), 15 U.S.C. \textsection 77aa (1994 & Supp. V 1999).


15. \textit{See} SEC, \textit{supra} note 7, at 3.


On the other hand, the mandatory disclosure rules are the means to achieving informed investment decisions. This goal illustrates the SEC’s choice of fairness over efficiency; by prohibiting free market bidders from buying access to information, the SEC’s disclosure regime suppresses the pricing mechanism inherent in differentially valuable data. Disclosure rules effectively lower the price of information for individual investors. Moreover, disclosure rules work to create a flow of information that eliminates informational asymmetries among market participants. Ideally, such laws will raise the overall level of information in the market, which, in turn, will increase the stock market’s fundamental price
efficiency.\textsuperscript{21} When prices more accurately reflect stocks’ value, the allocation of resources will be optimal.\textsuperscript{22}

But the federal securities laws do not mandate the release of all information. Instead, much information exists in pockets, stored in isolated sources. Rational investors are motivated to discover such information because to trade from a vantage point of superior information is to shift the risk of loss to other investors. Despite this, information—a predicate of market efficiency—tends to be underproduced. This apparent paradox is attributable to two reasons.

First, information is like any other good in that it has a price. The price of information about a stock includes retrieval,\textsuperscript{23} processing,\textsuperscript{24} and verification costs.\textsuperscript{25} Given these costs, the individual investor searching for information

\begin{itemize}
\item \textsuperscript{21} Victor Brudney, \textit{Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws}, 93 \textit{Harv. L. Rev.} 322, 334 (1979). Fundamental efficiency is a measure of the degree to which the market price of a security expresses the fundamental worth of an issuer. \textit{Ian Ayres, Back to Basics: Regulating How Corporations Speak to the Market}, 77 \textit{Va. L. Rev.} 945, 968 (1991). Fundamental efficiency is distinguished from \textit{market efficiency} and \textit{informational efficiency}. Market efficiency can refer generally to either a market’s degree of fundamental efficiency or informational efficiency. \textit{Id.} at 968-69. Informational efficiency is the degree to which a stock price reflects the varying levels of information about the stock and is measured by one of the three forms of the Efficient Capital Markets Hypothesis (“ECMH”). \textit{Id.} at 965.

The weak form of the ECMH posits that the price of any given security will reflect a security’s history; that is, the prices at which the security has been bought and sold. \textit{Douglas R. Emery et al., Principles of Financial Management} 226 (1998). The semistrong form claims that prices quickly and neutrally impound public information about a stock. \textit{James H. Lorie et al., The Stock Market: Theories and Evidence} 65-73 (2d ed. 1985). The strong form of the ECMH asserts that prices reflect all information pertaining to a stock, including illegally-used inside information regarding an issuer. \textit{Emery et al., supra}, at 226; \textit{Lorie et al., supra}, at 73-77. Most agree that markets in the United States display semistrong efficiency. \textit{Lorie et al., supra}, at 73.

\item \textsuperscript{22} Brudney, \textit{supra} note 21, at 334.

\item \textsuperscript{23} Ronald J. Gilson & Reinier H. Kraakman, \textit{The Mechanisms of Market Efficiency}, 70 \textit{Va. L. Rev.} 549, 594 (1984). Gilson and Kraakman note that acquisition costs are of two types: (1) the cost of uncovering or “producing the information,” and (2) the costs of purchasing information produced by another. \textit{Id.} Information necessary for effective decisionmaking tends to be spread across various sources. \textit{Thomas Sowell, Knowledge and Decisions} 26 (1996). Thus, part of the costs of acquisition logically will include assembling pertinent data from disparate sources.

\item \textsuperscript{24} Gilson & Kraakman, \textit{supra} note 23, at 594. Processing costs include not only the actual analysis, but also the training necessary to interpret accounting, financial, and economic data. Gilson & Kraakman, \textit{supra} note 23, at 594. The professional’s wage expresses these costs. Gilson & Kraakman, \textit{supra} note 23, at 594.

\item \textsuperscript{25} Gilson & Kraakman, \textit{supra} note 23, at 594. Verification costs are also twofold. Gilson & Kraakman, \textit{supra} note 23, at 594; \textit{see also supra} note 23 (noting the duality of

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quickly reaches the point of diminishing returns: his or her opportunity costs become greater than the result of his or her untrained efforts. The price of profitable information\(^26\) simply becomes too high.

Second, information is underproduced because of its nature. Information is a pure public good;\(^27\) therefore, a researcher cannot completely internalize the benefit of his or her searches.\(^28\) Others, free riders, trade on the basis of the researcher's information without paying for it in an attempt to profit from the researcher's efforts.\(^29\) Thus, one has an incentive to invest one's resources

acquisition costs). The information producer must audit the information, whereas a subsequent purchaser must confirm the truthfulness of the producer. Gilson & Kraakman, supra note 23, at 594-95. Because of their reputational interests, securities analysts have an incentive to bond the information they bring to the market. Donald C. Langevoort, Investment Analysts and the Law of Insider Trading, 76 VA. L. REV. 1023, 1030 (1990). For a discussion on this latter point and how it relates to the lemons market problem, see infra note 59.

26. The qualifier "profitable" is important. Information that is widely available in the marketplace is not very valuable. Given a semistrong market, such information is already impounded into the price; as a result, an investor cannot profit from such information.

27. A public good is broadly defined as any good or service that provides benefits to all of society, such as clean air or national defense. See KARL E. CASE & RAY C. FAIR, PRINCIPLES OF ECONOMICS 459 (2d ed. 1992). Others further differentiate between public goods and collective goods. So classified, a public good (as opposed to a collective good) is any good or service that is nonrival in consumption—that is, it can be provided to any amount of people at no extra cost. Harold Demsetz, The Private Production of Public Goods, 13 J.L. & ECON. 293, 295 (1970); see also CASE & FAIR, supra, at 459. Collective goods are nonexcludable, meaning those goods that the producer cannot prevent others from consuming. Demsetz, supra, at 295; see also CASE & FAIR, supra, at 459. Finally, a "pure public good" combines both nonrivalness and nonexcludability. Kimberly D. Krawiec, Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age, 95 NW. U. L. REV. 443, 451-52 (2001).

28. Krawiec, supra note 27, at 453-54; see also RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 36 (5th ed. 1998) (noting that, without property rights in a resource, one has no assurance that one will reap the benefits of one's cultivation of that resource). See generally MARK SEIDENFELD, MICROECONOMIC PREDICATES TO LAW AND ECONOMICS 63-66 (1996) (explaining the economics behind externalities). Alternatively, a paid researcher is undercompensated for his or her investigative efforts because free riders are benefitting from the researcher's labor. John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 VA. L. REV. 717, 726-27 (1984) [hereinafter Coffee, Market Failure]. Either way, the net effect is that the level of market information is suboptimal. Id. at 726.

elsewhere, leaving the information undiscovered or for someone else to discover, or even to free ride one’s self.

The federal disclosure rules compensate for some of this underproduction by creating a floor beneath which the level of information in the market cannot sink. This provides the minimum for informed trading decisions, lowers the price of information, and reduces duplicative search costs, freeing researchers to spread their efforts elsewhere.

In summary, information is critical to market efficiency. As regulator of information and the capital markets, the SEC has attempted to create efficient and, more importantly, fair markets. Yet, the federal security laws do not require release of all information or even of all material information. Thus, gaps—isolated data waiting to be bundled to create the basis for investment decisions—exist and will continue to do so. To receive the socially optimal amount of information, then, there must be some mechanism, beyond the federal laws, that provides incentives to produce information and bring it to the market.


31. But see William O. Douglas & George E. Bates, The Federal Securities Act of 1933, 43 Yale L.J. 171, 172 (1933) ("Those who need investment guidance will receive small comfort from the balance sheets, statistics, contracts, and details which the prospectus reveals."); Homer Kripke, The Myth of the Informed Layman, 28 Bus. Law. 631, 632 (1973) ("My theme is that the theory that the prospectus can be and is used by the lay investor is a myth. It is largely responsible for the fact that the securities prospectus is fairly close to worthless.").

32. Coffee, Market Failure, supra note 28, at 733-34. But cf. Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 298-300 (1991) (asserting that it is not only disclosure that benefits investors but also the nature of the information that is disclosed).

B. The Securities Analyst, Informal Relationships,\textsuperscript{34} and Systemic Benefits

As noted, selective disclosure is a mechanism that provides incentives to produce information and bring it to the market. Selective disclosure fulfills an interstitial need for revealing information existing somewhere between what is required by mandatory disclosure rules and what may not merit the costs of public or voluntary SEC disclosure. Selective disclosure has resulted from the tripartite relationship among issuer, analyst, and investor. To understand this relationship and selective disclosure’s important role, this Law Summary examines the analyst’s role in relation to the publicly-traded company and the investor.

In their capacity as informational intermediaries, security analysts are hired by both individuals and firms in the hopes that the analysts’ product will provide a profitable informational advantage.\textsuperscript{35} Financial institutions, such as mutual funds and brokerage firms, hire analysts as part of the basket of services offered to investors; these entities also may use the analysts to trade for their own accounts.\textsuperscript{36} Individual investors also may hire analysts by retaining the services of an investment management firm.\textsuperscript{37} In both situations, the analyst is employed to discover new information about securities issuers and make recommendations to clients, whether institutional or individual.

One of the ways an analyst does this is by researching the public information about the issuer, such as SEC filings or economic data.\textsuperscript{38} However, merely gathering and assessing public information soon leads to diminishing returns for the analyst. The semistrong form of the Efficient Capital Markets Hypothesis (“ECMH”) instructs that such information is already impounded into the price of the security.\textsuperscript{39} According to the semistrong orthodoxy, the analyst’s research of publicly available information does not add to society’s wealth of information regarding that stock. Some new way of adding material, nonpublic information

\textsuperscript{34} As used herein, an informal relationship will refer not only to a familiar or collegial relationship between parties, but also to an institution for decisionmaking. See Sowell, supra note 23, at 23-30.

\textsuperscript{35} See Langevoort, supra note 25, at 1025; see also David Hirshleifer et al., Security Analysis and Trading Patterns When Some Investors Receive Information Before Others, 49 J. Fin. 1665, 1665 (1994) (“By [receiving information] first, an investor can exploit this information to great advantage. Information that is uncovered only slightly later is less valuable even if it has not yet been publicly revealed.”).

For purposes of this Law Summary, a “security analyst” refers to professionals hired to acquire information and make recommendations about securities.

\textsuperscript{36} Langevoort, supra note 25, at 1026.

\textsuperscript{37} Langevoort, supra note 25, at 1026.

\textsuperscript{38} Barry, supra note 29, at 1308.

\textsuperscript{39} See Seligman, supra note 7, at 605.
is necessary in order to increase informational and fundamental efficiency. Selective disclosure is this new way, and it has developed, in part, as a result of the relationship between the analyst and a company.

In matters not governed by the securities laws, the relationship between an analyst and an issuer is an informal one because their interactions arise not as a result of a forced institutional arrangement but, instead, are voluntary and, thus, free of the costs of imposed relationships.\textsuperscript{40} For instance, the parties need not pay the costly “insurance”\textsuperscript{41} that is required to protect against future adverse costs in an imposed relationship; in the informal relationship, either one party’s decision is unilaterally sufficient to make decisions, or he or she is part of a relationship in which the others are adequately familiar with the setting to make such insurance superfluous.\textsuperscript{42} Institutional relationships, on the other hand, are less self-contained, typically involving costly formalities at various stages of the decision-making process.\textsuperscript{43}

Moreover, informal relationships allow the parties to negotiate the exchanges of that interaction. Knowledge conveyed in the relationship can be individualized to the parties’ needs, as opposed to the categorical nature of institutional arrangements.\textsuperscript{44} That knowledge also can be given incrementally, allowing the parties to choose the costs and benefits they will incur.\textsuperscript{45}

In the securities context, this means the issuer is free to decide to whom it will communicate and the level of that communication\textsuperscript{46}—in other words, to

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\textsuperscript{40} One should not be overly categorical here. Obviously, these relationships exist on a continuum. A recently-employed financial manager, for instance, can “inherit” a set of analysts with whom the company typically communicates. Thus, though the manager may be able to exercise some discretion as to the degree of that contact, his discretion will be constrained by the larger corporate culture. If the firm is smaller and less followed than others, the pressure will be greater to maintain that set of analysts so as to maintain lower disclosure costs. \textit{See infra} notes 55-57 and accompanying text.

\textsuperscript{41} \textit{See Sowell}, supra note 23, at 24. These costs—whether formalized requests to a bureaucratic authority, efforts to make clear one’s meaning, or sensitivity to an organization’s culture—constitute the lubrication required when coordinating with others toward a goal. \textit{See Sowell}, supra note 23, at 24.

\textsuperscript{42} \textit{See Sowell}, supra note 23, at 24.

\textsuperscript{43} \textit{See Sowell}, supra note 23, at 24. These formalities may include review by peers, committees, or superiors.

\textsuperscript{44} \textit{See Sowell}, supra note 23, at 24.

\textsuperscript{45} \textit{See Sowell}, supra note 23, at 24. Professor Sowell explains this by referring to package deals. With their “take-it-or-leave-it” nature, package deals reduce consumers’ options. \textit{See Sowell}, supra note 23, at 28-29. As noted earlier, the federal disclosure rules are a type of package deal: certain information must be disclosed, and the consumer of information must take it or leave it.

\textsuperscript{46} Again, there may be some corporate constraint here. \textit{See supra} note 40.
selectively disclose. Of course, the issuer’s relationships with analysts are still framed by the securities regulation laws. In his or her relations with an analyst, an issuer official still must be aware of possible liability based on either entanglement or adoption theories.\(^{47}\) But within the pre-Regulation FD legal and corporate constraints, the analyst and the issuer official have room to negotiate the terms of their interactions; to agree incrementally for the information to be revealed; and to signal the worth of the information disclosed by their respective willingness to incur the costs of the disclosure.

Typically, selective disclosure occurs between an analyst and a corporate insider.\(^{48}\) These contacts can occur on a sliding scale of formality, such as group meetings\(^{49}\) or conference calls that present a company’s plans,\(^{50}\) or, more informally, an individual analyst can telephone a company insider to clarify previously-released information.\(^{51}\)

In these interactions, the issuer and the analyst can negotiate what information will be released to the analyst. Because it is on their terms and tailored to their needs, the information is disclosed at a much lower cost than it would cost either of them otherwise.\(^{52}\)

\(^{47}\) Under the entanglement theory, a company becomes liable for an analyst’s report when that company’s level of involvement in the preparation of the report rises to such a level that it is as if the company had provided the information. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 163 (2d Cir. 1980). “Generally, when a company engages in conduct that expressly or impliedly represents to the analyst that the information being prepared by the analyst is correct or is endorsed by the company, liability under ‘entanglement’ theory is possible.” Bruce A. Hiler, Dealing with Securities Analysts: Recent Guidance, 28 SEC. REG. L.J. 180, 192 (2000).


\(^{48}\) See Langevoort, supra note 25, at 1026.


\(^{50}\) Jeff D. Opdyke, Individuals Pick Up on Conference Calls, WALL ST. J., Nov. 20, 2000, at C1 (“Conference calls are telephone sessions, typically lasting an hour or so, in which management lays out its views on the company’s recent performance and prospects for the future, dozens of analysts then lob questions at the executives.”); see also infra notes 186-88 (discussing the SEC’s suggestion that issuers post information regarding details of upcoming conference calls in order to provide sufficient notice under Regulation FD).

\(^{51}\) Langevoort, supra note 25, at 1026.

\(^{52}\) In 1980, the cost for disclosure under the SEC regime was estimated at more
For example, consider the financial officer who sees an opportunity to benefit the issuer by disclosing a piece of material, nonpublic information to the market that is not mandated by the disclosure rules. In such a situation, the range of options facing the officer depends upon the issuer’s size. The issuer could file the information with the SEC, but this is an expensive route to disclosure. The formal relationship between an issuer and the SEC requires rigid filing methods and rules—a package deal. Because of these costs, larger companies will have the ability to use this option more often than smaller companies.

Disclosing to the media is an option but, again, not an equal one for all companies. Press releases can be costly, and a smaller company must pay a higher price for such disclosure than a larger company must pay. Given finite newspaper space and airtime, press releases may not be reported in a timely fashion, if at all, by the various media outlets. Thus, in disclosing equivalent information, a smaller company may have to make a bigger “splash” than a blue-chip firm.


53. In 1975, a large company (defined as having $2.6 billion in assets) spent 0.034 percent of its assets on mandated disclosure. PHILLIPS & ZECHER, supra note 52, at 50 table 3.3. For a small company (i.e., a firm with $26 million in assets), the same disclosure increased to 0.46 percent. PHILLIPS & ZECHER, supra note 52, at 50 table 3.3.

54. See SOWELL, supra note 23, at 28-29.


56. Professor Coffee notes that SEC v. Stevens exemplifies this fact. Coffee, SEC, supra note 55. Though Ultrasystems (the issuer) released a press release on Friday, it was not until the following Monday that the news was reported and the stock’s price was affected. Coffee, SEC, supra note 55. Indeed, it seems that the media’s role is underestimated; given its incentive structure and constrained resources, it stands to reason that the media may act as a gatekeeper for some information that, in turn, could affect informational efficiency.

57. As scholars prune assumptions from the ECMH, one of the remaining questions is the degree to which the market absorbs information regarding small capitalization stocks such as those on the National Association of Securities Dealers Automated Quotations (“NASDAQ”). See Coffee, SEC, supra note 55. In 1991, there were twenty-seven percent fewer Wall Street analysts than in 1987. Debbie Galant, Is Small Beautiful?, 25 J. INVESTING 169, 169 (1991). In recent years, analysts have been taxed by more emerging companies that need to be followed. Id. This has forced many analysts to drop companies from their rolls, leaving those companies, and even entire sectors,
Alternatively, a public company’s financial officer can disclose selectively to analysts. Comparatively, the costs are lower. The company need not pay the price of disclosure required by the SEC or incur the costs associated with a press release; at the same time, the company may realize the benefits by releasing the information. For his or her part, the analyst is able to acquire facts crucial to his or her analyses, which leads to more accurate projections and models.

Moreover, a rational company director knows that other companies are also disclosing to the market. To compensate for adverse selection, the issuer relies upon the analyst to bond the information disclosed. Thus, the analyst acts as insurance for the issuer: because the analyst has his or her own reputational incentives, the analyst will not spread the information without being reasonably certain of its veracity.

The issuer also turns to the analyst based on liability concerns. The informal nature of their contact leaves an issuer and its agents less vulnerable to

unwatched. Id.

With this decrease in the ratio of analysts to companies (especially smaller, sparsely-traded companies), it is questionable whether semistrong efficiency applies to some companies. See Coffee, SEC, supra note 55. This is particularly true for those companies traded in the over-the-counter markets or not included in markets as large as the NASDAQ. See COX ET AL., supra note 16, at 39.

58. That is not to say they are costless. When responding to an inquiry “concerning rumors, unusual market activity, possible corporate developments or any other matter, the statement must be materially accurate and complete.” In re Carnation Co., Exchange Act Release No. 22,214, 33 SEC Docket 874 (July 8, 1985). The cost of selectively disclosing, then, may include the steps (i.e., time and resources) necessary to carry out the duty to update the disclosure or to implement policies to protect the issuer. Under the entanglement theory, an issuer has no duty to update or correct third-party reports that the issuer did not review or approve. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 163 (2d Cir. 1980).

59. See Langevoort, supra note 25, at 1030; see also Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 VA. L. REV. 669, 675-76 (1984) (highlighting the ways issuers can prove the quality of their stock, such as selling through investment bankers, having their managers hold large volumes of the stock, and issuing debt).

The compensation that issuers’ officials must make is reminiscent of the classic lemons market scenario: producers of quality goods do not market or must raise their prices to compensate for low-quality producers who bank on consumers’ lack of discernment. For a technical analysis of the lemons market, see George A. Akerlof, The Market for “Lemons”: Quality Uncertainty and the Market Mechanism, 84 Q. J. ECON. 488 (1970).

60. Thus, the benefit of bonding wraps around to the client, making it a positive sum gain.

61. Langevoort, supra note 25, at 1029.
a similar disclosure made publicly. The informal relationship between the
analyst and the issuer’s agent allows them to agree about who will bear the risks
of the information disclosed as the information can be off the record or tentative.

Further, when an issuer must release information to all, that information must
be simplified so that it is understood at the layman’s level: hence, limited
understanding requires limited disclosure. The informal relationship provided
by selective disclosure broadens the options available to a disclosing company,
allowing the issuer to fine tune its message to the recipient, improving the
disclosure’s information quality and increasing the informational efficiency of the
market.

Conversely, if an issuer wants to keep secret the details of a stock-enhancing
venture or development before it comes to fruition, a financial officer can use the
adaptable, informal relationship with an analyst to introduce the information
without specifics to the market. Hence, the price is moved without jeopardizing
the project.

Turning to the investor, it is easy to see how a rational investor could benefit
from the practice of selective disclosure to an analyst. Quite simply, the investor
needs information to make informed investment decisions. Due to their extensive
training and experience, analysts enjoy scale economies in their research efforts


63. It also can be improperly traded or misused. Some have suggested that a
financial officer would choose to disclose to those analysts who would trade material,
nonpublic information for favorable reports, especially when the analysts’ firm owns the
stock and, hence, will trade on the information early. Jeffrey M. Laderman, Wall Street’s
148; Langevoort, supra note 25, at 1040-42. However, reputational costs are natural
constraints upon this practice. Giving biased recommendations leads to poor results,
which decreases an analyst’s subscribers. See Langevoort, supra note 25, at 1043.

64. Langevoort, supra note 25, at 1043. Disclosed documents must be readable to
the average investor, free of superfluous technical jargon, and contain visual aids, such
as charts and graphs. 17 C.F.R. § 230.421 (2000); Preparation and Filing of Registration
23, 1980), available at 1980 WL 21018; Registration of Securities Offerings, Securities
20867.

65. See Langevoort, supra note 25, at 1030. Informational efficiency may not
improve, however, if an analyst obscures the grounds for his or her conclusions or
recommendations when speaking to the market.

66. See Langevoort, supra note 25, at 1031.

67. See Langevoort, supra note 25, at 1031.

68. See Langevoort, supra note 25, at 1031; see also Peter Lloyd Davies & Michael
Canes, Stock Prices and the Publication of Second-Hand Information, 51 J. Bus. 43, 55
(1978) (suggesting that the analyst’s product provides a profit opportunity to clients).
as compared to untrained investors; for the analyst, the price of retrieving, processing, and verifying information is much lower than for the untrained investor.\(^\text{69}\) The typical investor does not trade in a large enough volume to justify the associated research costs.\(^\text{70}\)

A multitude of investors researching companies creates substantial overlap and, hence, wasteful duplication of effort; the analyst streamlines this process.\(^\text{71}\) This liberates the investor to specialize in his or her own chosen area when, after all, he or she does not want to incur the costs of becoming a security analyst but, instead, wants the financial benefits of employing one.\(^\text{72}\)

As noted, much of the information distributed by issuers to the public must be generalized—stripped of its technicality.\(^\text{73}\) Disclosures to the SEC are formalized and costly to attain.\(^\text{74}\) With selective disclosure, the securities analyst can bring that information (in addition to other accumulated data) to the investor less expensively in a form particularized to the client, whether it be mere recommendations for the individual or a synthesized projection for an institution.\(^\text{75}\)

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69. Gilson & Kraakman, supra note 23, at 601 (noting that analysts have a “functional advantage . . . to process information more cheaply than non-specialists”).

70. Gilson & Kraakman, supra note 23, at 598 n.152.

71. Easterbrook & Fischel, supra note 59, at 675. Of course, too many analysts following the same companies also can be inefficient. See Coffee, Market Failure, supra note 28, at 733-34.

72. Easterbrook & Fischel, supra note 59, at 675. The SEC would argue that this supposition is contradicted by six-thousand comment letters. See infra note 86.

73. See Langevoort, supra note 25, at 1030.

74. See Langevoort, supra note 25, at 1030 n.25.

75. Some argue that there is little value to this service and that analysts in this capacity are merely middlemen. However, this notion is a variant of the physical fallacy, or the “belief in the invariable value of a physical object.” Sowell, supra note 23, at 67. Though this notion accounted for the prohibition of charging interest on borrowed money in medieval times, the middleman persisted because he acquired valued goods from producers and stored them until consumers needed them at a later time. Sowell, supra note 23, at 68. The middleman assumed the risk of this service, and, in so doing, changed the value of goods by relocating them in time and space at less cost than either the producer or the consumer. Sowell, supra note 23, at 68. Presumably, the producer and consumer would deal with each other directly but for the middleman’s economies of scale in inventory management and storage. Sowell, supra note 23, at 68.

Though information is intangible, a similar process works in the informational context. The analyst acquires the information from the issuer (producer) and stores it, albeit briefly. Typically, this information is combined with the other data that the analyst has. The analyst then can provide (relocate) it and any other analyst services to the investor (the consumer, who is unfamiliar with the process of information production and acquisition) at an agreed price and package. There is much room for debate on this point today, however, with the increased use of the Internet and the modern access to securities
Finally, selective disclosure reduces the cost of inside access for the average investor. The analyst offers the opportunity for such access and sophisticated market analysis to the individual investor in exchange for the analyst’s fee. If the individual investor is unwilling to pay the price (in terms of opportunity costs) required for such insight and access, he or she need only avail himself or herself of the analyst’s services.76

Ultimately, selective disclosure is a Coasian solution:77 after the initial allocation (and later incremental judicial development)78 of rights by Congress and the SEC, issuers’ officials, analysts, and investors contractually have arrived at selective disclosure in order to solve their respective problems efficiently. The transaction costs are low because investors, analysts, and issuers are all cheaply identifiable to one another, and each has an incentive to contract with the other. For the issuer and its officers, the informal relationship with the analyst is a low-cost disclosure and bonding mechanism; for the investor, it is a means to understandable inside information that allows for division of labor.

In addition, systemic benefits flow from this arrangement. Through the increased production of information, capital resources are more optimally allocated. All investors benefit through the production of information as informational, and then fundamental, efficiency increases. Hence, those investors who do not want to engage the services of an analyst can “free ride” on the market impoundment of the information.79 They do this by using the company’s stock price as a signal of quality as judged by the market.

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76. See Langevoort, supra note 25, at 1029. For commentary on the fairness of this arrangement, see also Frank H. Easterbrook, Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, 1981 SUP. CT. REV. 309, 330 (“People do not have or lack ‘access’ in some absolute sense. There are, instead, different costs of obtaining information. . . . The different costs of access are simply a function of the division of labor. . . . [B]ut unless there is something unethical about the division of labor, the difference is not unfair.”); Daniel R. Fischel, Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission, 13 Hofstra L. Rev. 127, 145-46 (1984) (arguing that those who do not employ analysts earn lower returns, but they do not incur the costs of those services).


78. See infra notes 95-143 and accompanying text.

79. But cf. Langevoort, supra note 25, at 1038 (“An investor possessing nonpublic information will purchase or sell additional securities of the issuer, but unless and until that information is somehow transmitted to other participants, the price will continue to reflect the uninformed view.”).
Also, as the practice of selective disclosure increases fundamental efficiency, it benefits shareholders. With the separation of ownership and control in the publicly-traded firm, the shareholders, as residual claimants, must incur the monitoring costs associated with that firm. However, it is impossible for the shareholders to monitor the firm’s relevant procedures and policies cost effectively; more realistically, the shareholders evaluate the company based upon its price. To the extent the analyst’s product contributes to the fundamental efficiency of an issuer’s stock (whether indicating high or low quality), monitoring costs are reduced, and the shareholders can make more accurate judgments.

Selective disclosure, then, creates a positive externality in economizing on the requirements for market efficiency and contributing to the efficient division of labor in society. Evidently, selective disclosure has many benefits to offer the market and individual investors. Nonetheless, the SEC disagrees that those benefits outweigh the costs.

C. The SEC and the Judicial Response to Selective Disclosure

According to the SEC, issuers’ selective disclosure undermines the SEC’s goal of fair and fully-informed markets. Hence, in the past, the SEC has sought to limit selective disclosure. This subsection explores how the SEC and the courts progressively have diverged in their respective treatment of liability for selective disclosure.

SEC officials have been quite candid about their reasons for disfavoring selective disclosure. With its ostensible tendency to favor analysts and their clients, selective disclosure jeopardizes the faith that investors have in capital

81. See Sowell, supra note 23, at 66 ("While the residual claimants cannot monitor the process, they can easily monitor the results.").
85. See infra notes 95-143 and accompanying text.
markets. Citing a recent study, the SEC also has rejected the supposition that selective disclosure is beneficial to the market.

Furthermore, the SEC considers the need for selective disclosure to have vanished with today's array of available disclosure methods. Selective disclosure, thus, is no longer a legitimate method of communicating with investors.

Lastly, the SEC views selective disclosure as an improper medium of exchange: issuer information for analysts' favor or deference. Such a quid pro quo approach to selective disclosure encourages biased analyses of companies, refutes the practice's supposed benefits, and, hence, turns information into disinformation.

86. Final Rule, 65 Fed. Reg. at 51,716. In neither Regulation FD nor the Proposing Release does the SEC offer empirical evidence to show a reduction in investor confidence from the practice of selective disclosure or any harm to the markets from such a reduction. Instead, the SEC offers the investor response in the form of the six-thousand comment letters it received after the SEC invited comment on Regulation FD in the Proposing Release; virtually all of the letters supported the rule. Final Rule, 65 Fed. Reg. at 51,717. This is an example of the public misjudging systemic benefits of the securities and information market, which leads to "actual harm resulting from policies designed to 'correct' perceived problems." Sowell, supra note 23, at 69.

87. Proposing Release, 64 Fed. Reg. 72,590, 72,592 (proposed Dec. 28, 1999). After presumptively declaring the "legitima[cy]" of some analysts' efforts in bringing information to the market, the SEC referred to Richard Frankel et al., An Empirical Examination of Conference Calls as a Voluntary Disclosure Medium, 37 J. ACCT. RES. 133 (1999). Proposing Release, 64 Fed. Reg. at 72,592. In that study, researchers examined the nature of firms using conference calls and the quality of the information disclosed. Frankel et al., supra, at 133-35. The study showed that firms that use conference calls tend to be larger and that material information is, in fact, disclosed during these calls. Frankel et al., supra, at 149-50. Moreover, the evidence indicated the issuer's trading volume increased during the period of the conference call. Frankel et al., supra, at 149-50. The article provocatively ends: "Unless all stockholders are provided equal access to these calls, this conduct seems inconsistent with the SEC's espoused goal of providing a 'level playing field' with regard to corporate disclosures." Frankel et al., supra, at 150.


90. Final Rule, 65 Fed. Reg. at 51,716-17; see also Laderman, supra note 63 (reporting on the pressures on analysts to exaggerate positive reports of some companies).

91. See Langevoort, supra note 25, at 1040-42.

92. As to those benefits, see supra notes 52-83 and accompanying text.
To the SEC, selective disclosure resembles its ill-favored brother, insider trading. Yet, although they both emerged from the same family of laws, one has been defended incrementally by the case law, the other suppressed. Nonetheless, the SEC's desire to limit selective disclosure has led to its persistent litigation in this area.

Chiefly, the SEC has attempted to deter selective disclosure by using 10b-5 liability. The past thirty years of case law, however, has diminished the threat 10b-5 poses to analysts conducting legitimate activities, i.e., receiving information without any breach of a fiduciary duty. Increasingly, analysts have found a safe harbor in the development of 10b-5 liability. In response, the SEC has adapted its theories in a continual effort to target selective disclosure.

In re Investors Management Co. was an early case in which the SEC used a parity of information theory of fraud to find liability for selective disclosure.


95. Section 10(b) of the 1934 Exchange Act gives "authority to the SEC to prohibit "any manipulative or deceptive device or contrivance" in the selling or purchasing of stocks. BAINBRIDGE, supra note 16, at 25 (quoting Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994)). Rule 10b-5 allows the SEC to sue those who have used fraud or made material misstatements or omissions in connection with the purchasing or selling of a stock. BAINBRIDGE, supra note 16, at 29; see 17 C.F.R. § 240.10b-5 (2000).


97. The parity of information theory posits that all investors should have "relatively equal access to material information" in order to achieve a fair and efficient marketplace. Bruce A. Hiler, Dirks v. SEC—A Study in Cause and Effect, 43 MD. L. REV. 292, 297 n.27 (1984).
In the 1960s, an SEC examiner charged investment advisors with violating or aiding and abetting violations of § 17(a) of the Securities Act of 1933, and § 10(b) and Rule 10b-5 of the Exchange Act. In Investors Management Co., the advisors had received selectively-disclosed information from officials of Douglas Aircraft Co., a commercial airline producer. Because the advisors knew that the information was nonpublic and material, that it had been acquired "improperly by selective revelation," and that the information induced their transactions, the defendants had violated the antifraud prohibitions.

The SEC has not stopped with holding analysts liable but, instead, has attacked the problem from both ends. In deterring selective disclosure, the SEC historically has pursued 10b-5 actions against disclosing companies and their


100. Securities Act of 1933 § 17(a), 15 U.S.C. § 77 (1994 & Supp. V 1999); see also Aaron v. SEC, 446 U.S. 680, 691 (1980) (holding that scienter must be shown in an action brought under § 17(a)(1), but not § 17(a)(2) or § 17(a)(3), in order to accord with congressional intent).


103. Based on the information, the investment advisors subsequently sold their shares of Douglas Aircraft. Id. at *3. In addition, they recommended to brokers, fund managers, and those expressing interest in the stock that any holdings in Douglas Aircraft be sold. Id.

104. Id. at *9.
agents. For instance, in *SEC v. Bausch & Lomb, Inc.*,\(^{105}\) the SEC attempted to impose liability on the company and one of its executives on the theory of tipping securities analysts.\(^{106}\) The SEC claimed an official had violated § 10b and Rule 10b-5 of the Exchange Act by selectively disclosing to analysts.\(^{107}\) The United States District Court for the District of New York denied the SEC the relief it sought.\(^{108}\) Because the court found that the official did not trade any information for his own benefit, he consequently lacked the required mental state.\(^{109}\) Moreover, the SEC’s request for injunctive relief was inappropriate given the improbability of future violations by the defendants.\(^{110}\) Although the SEC

105. 420 F. Supp. 1226 (S.D.N.Y. 1976), aff’d, 565 F.2d 8 (2d Cir. 1977). In this case, the SEC also sought injunctions against the securities analysts who received the information, but those analysts consented to the judgments before the trial. *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 14 n.14 (2d Cir. 1977).

106. Liability for tipping is a variant of 10b-5 liability. It involves an insider who does not trade on the basis of inside information himself or herself but rather “tips” others to that information who then trade on that information. *In re Cady, Roberts & Co.*, No. 8-3925, 1961 WL 3743, at *4 (SEC Nov. 8, 1961); see also BAINBRIDGE, supra note 16, at 41-42 (discussing Cady and tipping liability).

107. The interviews consisted mostly of the analysts seeking commentary on their earnings estimates for the company, their recommendations, and Bausch & Lomb’s plans to adapt to recent reversals. *Bausch & Lomb*, 565 F.2d at 11-12. One of the analyst’s ensuing recommendations and earnings revision was interpreted by “the Wall Street grapevine” as an actual Bausch & Lomb release of a similarly depressed earnings estimate. *Id.* at 13.


109. *Bausch & Lomb*, 420 F. Supp. at 1242. To prove a violation under Rule 10b-5 of the Exchange Act, it must be shown that the defendant acted with *scienter*, or an intent to deceive or defraud. 17 C.F.R. § 240.10b-5 (2000); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 211 (1976). Moreover, scienter must be shown in either a private action under Rule 10b-5 or an SEC enforcement action. Aaron v. SEC, 446 U.S. 680, 691 (1980). Subsequent courts have incorporated the common law conjoining of recklessness and scienter in order to satisfy the fraud requirement of Rule 10b-5 actions. See Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977), cert. denied, 450 U.S. 1005 (1981). For further discussion and details of the recklessness standard as it pertains to Rule 10b-5, see also 2 HAZEN, supra note 16, § 13.4, at 80-86 (elaborating on the 10b-5 scienter element and its district variations); Allan Horwitz, *The Neglected Relationship of Materiality and Recklessness in Actions Under Rule 10b-5*, 55 BUS. LAW. 1023, 1023-24 (2000) (asking whether an actor should be held to a recklessness standard when he or she negligently concludes that the fact he or she has omitted is actually material).

110. *Bausch & Lomb*, 420 F. Supp. at 1243. The SEC must show that there is a reasonable likelihood that the previous infraction will be repeated. *SEC v. Pros Int’l, Inc.*,
appealed to the Second Circuit, the appellate court affirmed the lower court's ruling. 111

Bausch & Lomb was the beginning of setbacks for the SEC in fighting selective disclosure. In nuanceding the duty of disclosure in 1980, the United States Supreme Court began a trend that would ease restraints on selective disclosure. In Chiarella v. United States, 112 the Court held that mere possession of material, nonpublic information does not give rise to a duty of disclosure under §10(b) of the 1934 Securities Exchange Act. 113 Rather, a duty to disclose exists when a party (such as a corporate insider) owes a fiduciary duty to another (i.e., a shareholder) and possesses material information. 114 Moreover, a tippee assumes, in effect, not only information from the insider but also inherits a duty to disclose or abstain from trading: he or she becomes a “participant after the fact” to the insider's breach of his or her fiduciary duty. 115

Subsequently, Dirks v. SEC 116 not only built upon the liability scheme but also protected issuers’ continued use of selective disclosure to securities analysts. In 1973, Raymond Dirks, a securities analyst, learned from a former official about

994 F.2d 767, 769 (10th Cir. 1993). The probability is judged by the “totality of the circumstances.” SEC v. Mgmt. Dynamics, Inc., 515 F.2d 801, 807 (2d Cir. 1975).

111. Bausch & Lomb, 565 F.2d at 19. Writing for the court, Chief Judge Irving R. Kaufman authored the vivid metaphor comparing the relationship between an analyst and a corporate executive to a “fencing match conducted on a tightrope” wherein the executive must “parry . . . incisive questioning.” Id. at 9. This is picturesque language to be sure, but it is no longer apt; the relationship between an executive and an analyst is scarcely so hostile any more nor would the executive attempt to block the questions. See supra notes 40-67 and accompanying text. Nonetheless, Chief Judge Kaufman’s analogical trope has become standard in discussions of analyst-executive interactions. See, e.g., J. Scott Colesan, Bouncing the Tightrope: The S.E.C. Attacks Selective Disclosure, But Provides Little Stability for Analysts, 25 S. Ill. U. L.J. 1 (2000); Commissioner Laura S. Unger, Fallout from Regulation FD: Has the SEC Finally Cut the Tightrope?, Speech at the Glasser LegalWorks Conference on SEC Regulation FD (Oct. 27, 2000), available at http://www.sec.gov/news/speech/spscb421.htm (last modified Nov. 13, 2000).

For a discussion and critique of judicial opinions as a literary source, see RICHARD A. POSNER, LAW AND LITERATURE 233-302 (1998).


113. Id. at 235.

114. Id. at 228. In the insider trading context, a fiduciary duty prohibits the agent from using information that he or she gained because of his or her position within a corporation for his or her personal benefit. Id. at 240; see also United States v. O'Hagan, 521 U.S. 642, 653 (1997) (affirming the misappropriation theory of insider trading); BAINBRIDGE, supra note 16, at 94-112 (summarizing the development of the misappropriation theory).


fraud occurring at Equity Funding of America.\textsuperscript{117} Mr. Dirks attempted to verify the claims and inform the public, going so far as to notify the press, to no avail.\textsuperscript{118} During this process, Mr. Dirks was open about his information, and those with whom he communicated began to sell their holdings in Equity Funding.\textsuperscript{119} Because Mr. Dirks’s efforts led to a significant price drop in Equity Funding, the fraud was eventually exposed.\textsuperscript{120} However, the SEC accused Mr. Dirks of violating the securities laws by refusing either to disclose the information publicly or refrain from trading.\textsuperscript{121} Mr. Dirks’s “extensive investigative efforts”\textsuperscript{122} and attempts at disclosure to the world’s leading financial newspaper in the face of others’ inaction to the allegations\textsuperscript{123} ameliorated his violation; thus, the SEC merely censured him.\textsuperscript{124}

The Supreme Court overturned Mr. Dirks’s censure.\textsuperscript{125} In so holding, the Court rejected the SEC’s supposition that the antifraud provisions of the 1934 Securities Exchange Act demanded informational equality in the marketplace.\textsuperscript{126}

\textsuperscript{117} Id. at 648-49. Ronald Secrist, an erstwhile officer of Equity Funding of America, tipped Mr. Dirks to the fraudulently exaggerated assets of the corporation so that Mr. Dirks would investigate the claims and reveal the fraud publicly. Id. at 649. This was not the first intimation of fraud at Equity Funding. Id. at 650 n.3. The United States Court of Appeals for the District of Columbia noted that the SEC “repeatedly missed opportunities” to bring to a halt the fraud at Equity Funding. Dirks v. SEC, 681 F.2d 824, 829 (1982), rev’d, 463 U.S. 646 (1983).

\textsuperscript{118} Dirks, 463 U.S. at 649. Mr. Dirks interviewed Equity Funding officials and employees at the corporation’s headquarters in Los Angeles. Id. Mr. Dirks also contacted the Wall Street Journal’s Los Angeles Bureau Chief William Bundell who declined to report the story, fearing a libel action. Id. at 649-50.

\textsuperscript{119} Id. at 649. Neither Mr. Dirks nor his firm traded or owned any holdings in Equity Funding, but clients and other investors with whom Mr. Dirks spoke sold their shares. Id. This included five investment advisors who sold more than $16 million in Equity Funding stock. Id.

\textsuperscript{120} California insurance authorities seized Equity Funding’s records, and the SEC filed a complaint against the corporation. Id. at 650. Equity Funding went into receivership, and twenty-two of its officials were convicted or pleaded guilty in subsequent trials. Id. at 650 n.4.


\textsuperscript{122} Dirks, 463 U.S. at 652 n.8.

\textsuperscript{123} See supra note 118.

\textsuperscript{124} Dirks, 463 U.S. at 651-52. It was Mr. Dirks’s attempts to inform and the SEC’s response that have made his story de rigueur in any discussion of insider trading and analysts, if only for the shock value.

\textsuperscript{125} See id. at 667.

\textsuperscript{126} See id. at 657.
Instead, the Court noted that vigorous markets are predicated upon securities analysts.\(^{127}\) To require that one must elect between disclosure or trading abstention upon receipt of material, nonpublic information—the grist of the security analyst’s mill—would have an “inhibiting influence on . . . analysts.”\(^{128}\)

Moreover, the Court accommodated selective disclosure by refining the analysis begun in *Chiarella*.\(^{129}\) According to the Court, for there to be a breach that would threaten the tippee with derivative liability under the securities laws, the insider must have disclosed in order to benefit personally, either directly or indirectly.\(^{130}\)

In Mr. Dirks’s case, he was a “stranger to Equity Funding, with no preexisting fiduciary duty.”\(^{131}\) He was entrusted with the information so that he could expose the fraud.\(^{132}\) Neither a fiduciary nor improperly tipped, then, Mr. Dirks was not bound to disclose or refrain from trading—no duty, no violation, no censure.

Eight years later, in *SEC v. Stevens*,\(^{134}\) the SEC latched onto the required “personal gain”\(^{135}\) of *Dirks* to find liability in a case of selective disclosure to

\(^{127}\) See id. at 658; see also Chiarella v. United States, 445 U.S. 222, 234 (1980) (making a similar exception, based on congressional intent, for market specialists who “contribute to a fair and orderly marketplace at the same time they exploit the informational advantage that comes from their possession of buy and sell orders”).

\(^{128}\) Dirks, 463 U.S. at 658.

\(^{129}\) See supra notes 112-15 and accompanying text.

\(^{130}\) Dirks, 463 U.S. at 662. The Court went on to admit that determining when an insider benefits from improper disclosure may be difficult in some cases, but “objective facts and circumstances” will guide the determination. Id. at 664. Where the insider’s disclosure is part of a quid pro quo or is intended as a gift for the tippee, a personal benefit occurs and liability ensues. Id. The benefit received is not to be defined too narrowly: it can consist of the outright cash value, reputational standing, or even exchanged information. Id. at 663. The Court quoted Professor Victor Brudney: “‘The theory . . . is that the insider, by giving the information out selectively, is in effect selling the information to its recipients for cash, reciprocal information, or other things of value for himself.’” Id. at 663-64 (quoting Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 348 (1979)).


\(^{132}\) Dirks, 463 U.S. at 649.

\(^{133}\) Id. at 664-65.


\(^{135}\) Dirks, 463 U.S. at 662.
analysts. The SEC filed a complaint against Phillip J. Stevens, the founder and chief executive officer of Ultrasystems Corporation, for correcting disclosures that he had made to analysts before making a public disclosure of those same corrections. The SEC asserted that Mr. Stevens made the disclosures because, in 1984, an analyst following the American Stock Exchange-traded corporation publicly confronted Mr. Stevens about his portrayal of Ultrasystems's financial numbers after a surprisingly negative earnings release. According to the SEC, Mr. Stevens's professional standing and earning ability were threatened by this challenge. Therefore, he reaped an improper Dirks benefit from the disclosure of material, nonpublic information. Rather than contest the enforcement action, Mr. Stevens acceded to an immediate consent decree at the same time that the SEC filed the complaint.

Thus, a backward glance across the legal landscape of the twentieth century reveals that an issuer has no duty to reveal material information solely because it

139. Coffee, SEC, supra note 55.
141. “Stevens perceived this challenge as injurious to his professional reputation and as placing in jeopardy his continued earnings power as a chief executive and a manager.” Id. at *1.
142. Id. For a discussion of Dirks, see supra notes 116-33 and accompanying text. Given the Court's dicta in Dirks regarding the importance of analysts, it is unlikely that the Supreme Court meant for the personal benefit that is a metric of improper disclosure to stretch so broadly. See supra notes 127-28 and accompanying text. Nonetheless, this type of personal benefit—the trading of material, nonpublic information for analyst favor—would become the impetus for Regulation FD. Final Rule, 65 Fed. Reg. 51,716, 51,716 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts. 240, 243, & 249). For a detail of this alleged practice in the corporate world, see also Laderman, supra note 63.
is material. An issuer does not violate the securities laws when its officers disclose material, nonpublic information to individual parties if such disclosure does not violate an independent fiduciary duty and no personal benefit accrues to the insider. An unchallenged theory of personal benefit, however, stands poised to open the door to liability in all selective disclosures to analysts. Yet, rather than pursue this avenue, the SEC instead would rely upon its rule-making authority to reduce the incidence of selective disclosure in the future.

III. RECENT DEVELOPMENTS

Rather than as an antifraud rule, the SEC announced Regulation FD as an issuer disclosure rule under its authority embedded in § 13(a) and § 15(d) of the 1934 Exchange Act. To begin, the core of Regulation FD, Rule 100, is stated in its finalized entirety. A more detailed examination of its elements follows, including those antecedents to any duties of which corporate counsel now must be aware. Finally, a summary of the duties is provided.

Rule 100 is the general rule of Regulation FD, and states that:

144. Coffee, SEC, supra note 55. Professor Coffee suggests this theory of personal benefit “trivializes Dirks” and criticizes the theory on several grounds. Coffee, SEC, supra note 55. First, it is in the shareholders’ interest for the chief executive officer to specify numbers given to analysts when projections have gone astray; this increases the company’s credibility with analysts. Coffee, SEC, supra note 55. The benefit to the corporation, then, is the benefit to the shareholders. Coffee, SEC, supra note 55. Secondly, as chief executive officer, chairman of the board, and substantial stockholder of Ultrasystems, whatever benefit Mr. Stevens received was incidental to the benefit that also accrued to the shareholders. Coffee, SEC, supra note 55. Lastly, as a smaller company, Ultrasystems had a legitimate interest in maintaining credibility with analysts who tracked the stock but received erroneous information. Coffee, SEC, supra note 55.

145. Because Regulation FD was not announced as an anti-fraud rule, the SEC was able to avoid “insider trading issues.” Proposing Release, 64 Fed. Reg. 72,590, 72,594 (proposed Dec. 28, 1999).

146. Proposing Release, 64 Fed. Reg. at 72,594. The SEC also notes that couching Regulation FD as a disclosure rule is more consistent with the regulation being used as a means toward full and fair disclosure. Proposing Release, 64 Fed. Reg. at 72,594.

On the same day it adopted Regulation FD, the SEC adopted Rule 10b5-1, a new rule relating to insider trading implications of a trader’s “use” or “knowing possession” of material, nonpublic information. Final Rule, 65 Fed. Reg. at 51,737. Also, the SEC released Rule 10b5-2, which announces under what circumstances the misappropriation theory of insider trading is applied to familial or other non-business relationships. Final Rule, 65 Fed. Reg. at 51,738. This Law Summary does not consider either of these additional rules.
(a) Whenever an issuer, or person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any person described in paragraph (b)(1) of this section, the issuer shall make public disclosure of that information as provided in § 243.101(e):

(1) Simultaneously, in the case of an intentional disclosure; and
(2) Promptly, in the case of a nonintentional disclosure.147

A. Antecedents to Duties Under Regulation FD

1. Issuers and Recipients Subject to and Excluded from Regulation FD

Regulation FD blankets many issuers: all issuers that are registered under § 12 of the 1934 Exchange Act, as well as all issuers that must file reports under § 15(d) of the 1934 Exchange Act, are subject to Regulation FD.148 Further, disclosures by "any person acting on behalf of the issuer" are also covered.149

Rule 100(b)(1) lists the four categories of information recipients subject to Regulation FD. The four categories are:

(i) . . . a broker or dealer, or a person associated with a broker or dealer, . . . (ii) . . . an investment adviser; . . . (iii) . . . an investment company . . . or [its] affiliated person; . . . or (iv) . . . 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.150

The SEC's goal in constructing this scheme was to streamline Regulation FD so as only to apply to individuals most likely to receive selectively-disclosed information.151 Thus, Regulation FD does not extend to communications with other businesses, the government, or the media.152

149. Final Rule, 65 Fed. Reg. at 51,738. Such persons include "any senior official of the issuer . . . or any other officer, employee, or agent of an issuer who regularly communicates with [securities professionals] or with holders of the issuer's securities." Final Rule, 65 Fed. Reg. at 51,739. Rule 101(d) defines "senior official" as "any director, executive officer, . . . investor relations or public relations or any other person with similar function." Final Rule, 65 Fed. Reg. at 51,739.
Rule 100(b)(2) of Regulation FD also contains four exclusions, generally classified as exempt recipients except for the last category. The first two exclusions apply to: (1) disclosures to those who are obligated by a “duty of trust or confidence to the issuer,” 153 and (2) those who expressly agree to keep the selectively-disclosed information confidential. 154 The third exemption applies to credit rating services, so long as the selectively-disclosed information is used for such purposes and the ratings are made public. 155 The fourth exemption applies to a type of selective disclosure rather than the recipient. With some exceptions, Regulation FD does not apply to disclosures that are made in connection with a public offering of a security registered under the Securities Act. 156

2. Material, Nonpublic Information

Regulation FD pertains only to informational disclosures that are material and nonpublic. 157 When examining potential disclosures, corporate counsel may rely upon antecedent definitions of “material” 158 and “nonpublic” 159 developed by case law. 160 The SEC enumerated an admittedly incomplete list of items that should be carefully considered as possibly material:

154. Final Rule, 65 Fed. Reg. at 51,720. Regulation FD need not apply to these individuals because liability could be found under either their status as temporary insiders or the misappropriation theory of insider trading.
155. Final Rule, 65 Fed. Reg. at 51,738. This exception was a change from the proposed regulation and was prompted by the comments the SEC received. Final Rule, 65 Fed. Reg. at 51,720.
158. For the definition of materiality, see supra note 6. The SEC suggested ways to ease the burden of real-time materiality judgments: (1) funnel information requests to authorized spokespersons; (2) keep records of private communications with those subject to the regulation (perhaps by adding a third person to the conversations, or recording them); (3) postpone answers to questions that might implicate the regulation until its materiality can be ascertained; (4) alternatively answer the question, but secure the questioner’s confidentiality and abstention from acting upon it until, again, the answer’s materiality is discerned and publicly disclosed if necessary; or (5) employ the regulation’s device for unintentional disclosures when needed. See Final Rule, 65 Fed. Reg. at 51,721 n.44.
159. Information is nonpublic if it has yet to be distributed in such a manner so as to make it generally known to investors. Final Rule, 65 Fed. Reg. at 51,721.
(1) [e]arnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a contract); (4) changes in control or in management; (5) change in auditors or auditor notification that the issuer may no longer rely on an auditor’s audit report; (6) events regarding the issuer’s securities—e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and (7) bankruptcies or receiverships.161

Corporate counsel should be especially alert to any guidance from analysts regarding earnings data.162 Where the issuer’s agent confirms or refutes—either directly or indirectly—the analyst’s projections, that agent probably has subjected the issuer to liability under Regulation FD.163 On the other hand, an analyst’s own insight as to some information will not make otherwise immaterial information material; thus, an agent’s disclosure of that specific information to the analyst will not involve Regulation FD.164

Lastly, the agent’s awareness regarding the particular disclosure is critical. The SEC agreed with commentators that the materiality requirement is part of the analysis of one’s intention for purposes of required, subsequent public disclosure.165 Thus, Rule 101(a) states that a party selectively discloses intentionally only if he or she knows, or is reckless in not knowing, that the information is material and nonpublic.166

3. Intentional and Non-intentional Disclosures

Under Regulation FD, the intent behind the selective disclosure is an operative fact. If the selective disclosure is intentional, then an issuer has a duty

161. Final Rule, 65 Fed. Reg. at 51,721. The SEC notes that this list is not to be interpreted as an exhaustive menu of per se material items. See Final Rule, 65 Fed. Reg. at 51,721.
166. Final Rule, 65 Fed. Reg. at 51,738. For more on the intentional and non-intentional distinction, see infra notes 167-72 and accompanying text.
to make a simultaneous public disclosure;\textsuperscript{167} if it is unintentional, then, the duty requires a prompt public disclosure.\textsuperscript{168}

Rule 101(a) of Regulation FD states that an issuer intentionally makes a selective disclosure when the issuer or person acting on behalf of the issuer "making the disclosure either knows, or is reckless in not knowing, [prior to making the disclosure] that the information he or she is communicating is both material and nonpublic."\textsuperscript{169} Thus, given the way federal courts are currently interpreting recklessness, the SEC has noted that an issuer's good faith effort to stay within the bounds of Regulation FD probably would not be considered reckless.\textsuperscript{170}

Regulation FD provides a safe harbor in cases where the disclosure is non-intentional.\textsuperscript{171} If a spokesperson selectively discloses due to a misunderstanding about the information's materiality, liability ensues only if "no reasonable person under the circumstances would have made the same determination."\textsuperscript{172}

\textbf{B. Duties Under Regulation FD}

In keeping with precedent, Regulation FD does not mandate the release of information because it is material or nonpublic. Instead, to avoid liability under Regulation FD, an issuer cannot disclose intentionally material, nonpublic information without also making a simultaneous public disclosure.\textsuperscript{173} For non-intentional selective disclosures, however, the issuer must make a \textit{prompt} public disclosure.\textsuperscript{174} This subsection explores the duties of public and prompt disclosure required by Regulation FD.

\begin{itemize}
\item \textsuperscript{167} Final Rule, 65 Fed. Reg. at 51,738. The SEC does not define "simultaneously" for purposes of Regulation FD.
\item \textsuperscript{168} Final Rule, 65 Fed. Reg. at 51,738. The nature of the prompt and public disclosure is explored \textit{infra} in notes 175-90 and accompanying text.
\item \textsuperscript{169} Final Rule, 65 Fed. Reg. at 51,738. This definition of "intentional" was considered most apt because it shares the mental state required to show fraud in other actions. Final Rule, 65 Fed. Reg. at 51,722. For a discussion regarding the mental state of scienter, see \textit{supra} note 109.
\item \textsuperscript{170} Final Rule, 65 Fed. Reg. at 51,722. As examples, the SEC cites to \textit{Hollinger v. Titan Capital Corp.}, 914 F.2d 1564 (9th Cir. 1990), \textit{cert. denied}, 499 U.S. 976 (1991), and \textit{Sunstrand Corp. v. Sun Chemical Corp.}, 553 F.2d 1033, 1045 (7th Cir. 1977), \textit{cert. denied}, 434 U.S. 875 (1977).
\item \textsuperscript{172} Final Rule, 65 Fed. Reg. at 51,722.
\item \textsuperscript{173} Final Rule, 65 Fed. Reg. at 51,738.
\item \textsuperscript{174} Final Rule, 65 Fed. Reg. at 51,738.
\end{itemize}
1. The Duty of Public Disclosure

Rule 101(e) defines the necessary public disclosure under Regulation FD. An issuer can satisfy the public disclosure requirement in one of two ways: (1) filing a Form 8-K, or (2) otherwise disclosing in a manner that is "reasonably designed to provide broad, non-exclusionary distribution of the information to the public." Due to the comments it received, the SEC modified the first option of Form 8-K filing. First, the SEC stipulated that an issuer is not deemed to have made any assertions regarding the information's materiality just because the information was submitted on a Form 8-K. Secondly, corporate counsel can comply with Regulation FD by filing a Form 8-K Item 5 report of the information, or furnishing a report of the same information under Item 9 of Form 8-K.

Under the second option provided by Rule 101(e)(2), issuers have the choice of how to satisfy the public disclosure requirements. Counsel must achieve a "broad, non-exclusionary distribution" method given the issuer's options and station in the market. This is an issuer-specific inquiry. To the extent the SEC must make that evaluation ex post, it reviews the entire constellation of facts and circumstances facing the issuer at the time of the decision on how to disclose.

176. Final Rule, 65 Fed. Reg. at 51,739. "SEC Rule 13a-11 requires the filing of current reports within 15 days of specified material changes in the issuer's financial condition or method of operations. Form 8-K is the appropriate form for these reports." Hazen, supra note 6, § 9.3, at 522 (citations omitted).
183. Final Rule, 65 Fed. Reg. at 51,724. Thus, Company A's large investor following may permit it to satisfactorily disclose by posting on the web as part of an array of disclosure methods, but Company B, with its more modest market retinue, may have to choose a number of additional methods to achieve public disclosure.
To highlight the SEC's expected level—but not necessarily method—of public disclosure, the finalized release offers a recommended tripartite model to issuers for satisfactory disclosure.\textsuperscript{185} First, the issuer can issue a press release to the "regular channels."\textsuperscript{186} The issuer then can give sufficient notice of a scheduled conference call for purposes of discussing the release.\textsuperscript{187} Finally, the issuer should convene the conference call "in an open manner."\textsuperscript{188}

2. The Duty of Prompt Disclosure

Under Rule 100(a)(2), where a selective disclosure is non-intentional, an issuer has a duty to make a public disclosure of the same information in a prompt manner.\textsuperscript{189} Corporate counsel should be aware that the senior official is the catalyst to a duty of prompt disclosure because Regulation FD defines \textit{promptly} in relation to a senior official. For purposes of the regulation, "promptly" means:

\begin{quote}
\[\text{[A]s soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange) after a senior official of the issuer (or, in the case of\]}
\end{quote}

\begin{itemize}
\item 186. Final Rule, 65 Fed. Reg. at 51,724. Although the SEC does not elaborate as to what those "regular channels" are in the Final Rule, in the Proposing Release, the SEC referred to Reuters, PR Newswire, Business Wire, Bloomberg, and Dow Jones. Proposing Release, 64 Fed. Reg. 72,590, 72,596 (proposed Dec. 28, 1999). The release should describe the information to be disclosed (or previously disclosed if done unintentionally).
\item 187. Final Rule, 65 Fed. Reg. at 51,724. To effect notice, the SEC suggests a press release or posting on the issuer's web site giving details as to the time and date of the call, as to the ways the individual investors can access the call. Final Rule, 65 Fed. Reg. at 51,724.
\item 188. Final Rule, 65 Fed. Reg. at 51,724. "Open manner" does not mean that investors have the option of asking questions during the call. Final Rule, 65 Fed. Reg. at 51,724 n.71. To allow further access, the SEC recommends that issuers using conference calls or webcasts as part of their disclosure ought to consider making the recorded call or conference available for a "reasonable period of time" to those who missed it. Final Rule, 65 Fed. Reg. at 51,724 n.73.
\item The SEC expects the cost of the required 8-K submissions will range from $34,937,500 to $49,562,500 per year. Final Rule, 65 Fed. Reg. at 51,732. This implies that the SEC thinks the loss of investor confidence and other consequences of selective disclosure exceed approximately $35 to $50 million per year, although the SEC has not quantified that loss. Conspicuously, the SEC does not offer any suggestions as to any possible offsetting benefits of selective disclosure. Measuring such costs, however, admittedly would be difficult.
\end{itemize}
a closed-end investment company, a senior official of the issuer’s investment adviser) learns that there has been a non-intentional disclosure by the issuer or person acting on behalf of the issuer of information that the senior official knows, or is reckless in not knowing, is both material and nonpublic. 190

C. Liability Under Regulation FD

If an issuer or someone acting on behalf of the issuer violates Regulation FD, and a safe harbor is not available, Regulation FD provides for issuer (and possible individual) liability. The SEC responds to violations of Regulation FD with the same array of options that it brings to bear against other infractions of issuer disclosure rules.

First, the SEC can bring an enforcement action against an issuer for violating its duties under § 13(a) and § 15(d) of the Exchange Act. 191 Alternatively, the SEC could bring a similar action against an individual or an administrative action against the issuer. 192

However, Rule 102 of Regulation FD specifically provides that an issuer does not violate Rule 10b-5 when it fails to make a required disclosure under the regulation. 193 Because the regulation is not intended to supplement duties under Rule 10b-5, the issuer’s counsel can find a safe harbor from private 10b-5 actions. 194

The SEC cautions, however, that Rule 102 will provide no protection against violations that implicate other rules in addition to Regulation FD. 195 Corporate counsel for the issuer still must be attuned to apparent instances of Dirks’s “personal benefit” inducing a selective disclosure; failing to update material

190. Final Rule, 65 Fed. Reg. at 51,739. The SEC helpfully illustrates how the rule works by hypothesizing that if a senior official discovers the improper disclosure on Friday after market close, there must be a public disclosure by the opening of trading as of the following Monday. Final Rule, 65 Fed. Reg. at 51,723. For the definition of “senior official” for purposes of Regulation FD, see supra note 149. 191. Final Rule, 65 Fed. Reg. at 51,726. For information on the SEC’s enforcement action, see supra note 98.


information submitted under Regulation FD; submitting similar materials containing false or misleading information; and the entanglement and adoption theories of liability.196

IV. DISCUSSION

Under its authority as information regulator, the SEC has promulgated a disclosure rule to fight what it openly considers a practice akin to insider trading.197 The SEC could not reach issuer liability for selective disclosure using the personal benefit doctrine, so the SEC altered its strategy. Instead, the SEC has categorized all disclosed information as requiring public disclosure. In other words, the SEC did away with questions of a personal benefit or a breach of fiduciary duty in order to find the heretofore elusive liability in selective disclosure cases.198

As noted, the Supreme Court and other courts effectively have ensconced selective disclosure.199 Rule 10b-5 has proved a clumsy tool for defeating that protection.200 The SEC’s task has been to stop selective disclosure within the constraints of those decisions. Particularly troublesome was the Court’s specific rejection of any notion that Congress intended the antifraud rules to be aimed toward the creation of parity of information.201

The SEC has never tested the Stevens theory of personal benefit. Indeed, the crucible of judicial review likely would have revealed the theory of Stevens for what it was—an unalloyed attempt to stretch Dirks’s personal benefit to selective disclosure inappropriately. The Court referred in dicta to the utility of analysts and their searches.202 Were the SEC’s Stevens benefit to be used, it could apply so widely that it effectively would outlaw the very disclosures approved by the Court.

As a result, the SEC had to devise a new tactic. Nevertheless, Regulation FD does not meet the need. It is a cumbersome, blanket prohibition that trades one form of “unfairness” for another and smothers a great deal of worthwhile activity.

198. This regulatory flexibility is what, according to Professor Seligman, has made the SEC so successful—its willingness to apply numerous regulatory tools to a perceived problem until a solution is found. See SELIGMAN, supra note 7, at 621.
199. See supra notes 112-33 and accompanying text.
200. “Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.” Chiarella v. United States, 445 U.S. 222, 234 (1980).
201. Id. at 223.
A. Regulation FD Does Not Level the Playing Field

One of the justifications for Regulation FD is that it levels the playing field.\textsuperscript{203} However, some contours are deepened, while others obstinately remain. First, Regulation FD subsidizes companies that more cheaply can make disclosures, while it penalizes those companies that disclose at greater cost.\textsuperscript{204} Though Regulation FD requires an issuer to post sufficient notice of a disclosure, what is sufficient varies from issuer to issuer.\textsuperscript{205} Large companies, with greater distribution channels, have every incentive to make public announcements: the issuer maintains its share of advertising in the market and contributes to the drowning out of those that disclose less.\textsuperscript{206} The media will carry these disclosures, and investors will follow them.\textsuperscript{207} However, because of their status in the market, any disclosures from these companies would have been publicized heavily anyway.

On the other hand, smaller companies with greater marginal disclosure costs must be more selective with their disclosures. To the extent the suggested disclosure of material, nonpublic information does not merit the required level of announcement, the small issuer will not disclose the information if the cost of public disclosure does not justify the expected benefit. Nevertheless, Regulation FD denies the small issuer the option of selectively disclosing to analysts; as a result, the smaller issuer’s capacity to add incrementally material information is replaced by an all-or-nothing requirement. Indeed, smaller companies are held to the same standards as the largest companies—despite their obvious differences.\textsuperscript{208}


\textsuperscript{204} See Sowell, supra note 23, at 232-37 (describing how administrative agencies’ regulations subsidize entire industries and penalize individual competitors not in compliance).

\textsuperscript{205} See supra notes 55-57 and accompanying text.

\textsuperscript{206} Statistics show that, after Regulation FD was announced, the number of earnings preannouncements increased fivefold. Jeff D. Opdyke, How Much are Stocks Hurting from Recent Rash of Profit Preannouncements Tied to New Rule?, WALL ST. J., Mar. 2, 2001, at C1 [hereinafter Opdyke, Stocks Hurting].

\textsuperscript{207} Thus, the level of information will rise on average as will the range of materiality. The issuer, thus, passes the costs on to the investor who now must do more research to reach an informed trading decision; must pay the cost of bidding improperly based on misunderstanding data; or must incur the costs associated with decreased attention to disclosures. Society also assumes the cost of imprudent investing as capital is not allocated to its most productive sources.

\textsuperscript{208} “[The SEC does] not believe different performance standards for small entities would be consistent with the purpose of Regulation FD.” Final Rule, 65 Fed. Reg. at 51,736.
With Regulation FD’s further restrictions upon smaller issuers, fundamental efficiency is decreased and capital formation is impeded.  

Furthermore, it is questionable whether the individual is genuinely benefitted by Regulation FD. Following an unintentional selective disclosure, the issuer has twenty-four hours from the time a senior official discovers the disclosure to correct it. Yet, those twenty-four hours are crucial: “larger investors trade in real time on the basis of information that is released during conference calls.”  

This is not to suggest, as others have, that the SEC was too generous in creating a safe

As to the differences between issuers, consider that smaller companies tend to rely upon outside counsel more than larger companies—indicating their costs for counsel-assisted disclosure will be greater. Coffee, SEC, supra note 55. Smaller companies also tend to avoid conference calls. Frankel et al., supra note 87, at 136. There is a positive correlation between a firm’s size and profitability, and the frequency with which it holds conference calls. Frankel et al., supra note 87, at 136.

209. The SEC asserted that Regulation FD encourages capital formation because it “enhance[s] investor confidence and participation in the markets.” Final Rule, 65 Fed. Reg. at 51,734. This bolstered faith in the markets, the SEC noted, will lead to increased market efficiency and facilitate capital formation. Final Rule, 65 Fed. Reg. at 51,734. This position is scarcely tenable. Judging from many of the letters, much of the investing public was unaware of selective disclosure, so the practice did not affect its contribution to the market; others apparently misunderstood the purpose of Regulation FD. See, e.g., Letter from Michael A. Choate (Mar. 21, 2000), available at http://www.sec.gov/rules/proposed/s73199/choate1.txt (last visited Nov. 9, 2001); Letter from Kaiwen Lin (Mar. 21, 2000), available at http://www.sec.gov/rules/proposed/s73199/lin1.txt (last visited Nov. 9, 2001); Letter from Bonnie Stroud (Dec. 26, 1999), available at http://www.sec.gov/rules/proposed/s73199/stroud1.txt (last visited Nov. 9, 2001). That others knew of selective disclosure but still invested shows that the practice did not inhibit them.

In short, Regulation FD does not provide any incentive to invest that was previously absent. The regulation will not encourage people who were avoiding the stock market suddenly to invest now that the days of selective disclosure are gone nor will it induce others to double their investing efforts.

210. Frankel et al., supra note 87, at 135.

211. Robert Conner argued that investors would have benefitted more from shortening the time a company’s staff has to correct an inadvertent disclosure. See Conner, supra note 171, at 276. With a shorter time period, argued Mr. Conner, an issuer’s officials would have a greater incentive to avoid such disclosures. Conner, supra note 171, at 277. Nevertheless, the tradeoffs of such increased protection may not be worth it. Those tradeoffs can include even more companies enacting more restrictive policies regarding communications; this implies further informational inefficiencies. Certainly a steeper period would give an incentive to make even more company investment (i.e., monitoring costs) against selective disclosure. Yet, some agency costs in this area would be inevitable as officers adjust or make simple oversights. See Robert
harbor for unintentional disclosures. Rather, it underscores the comparative advantage that cannot be overcome by regulation, an advantage for which analysts and institutional investors have paid the price.

For instance, by virtue of their training and experience, professionals and analysts still possess superior understanding as compared with the lay investor. This translates into an advantage the average investor cannot overcome without such training. To be sure, there are variations within each class, but, on average, as between the professional analyst and the average investor, the analyst will be able to make better use of information even when such information is received simultaneously by both the analyst and the investor.212 This is the very nature of being a professional analyst; analysts have paid the price—years of training and education—for such an advantage. Rather than calling for heavy-handed regulation, lay investors also can exploit this advantage by paying its price.

Furthermore, Regulation FD cannot remove the cost the average investor must pay for access to information.213 It is the analyst's job to monitor conference calls, and he or she has greater economies of scale in this regard. The average investor, however, must forego other opportunities in order to monitor these calls; if he or she is not a professional analyst, then these opportunities are probably more profitable than tuning into a webcast to hear an issuer's management discussions.214

McGough, E-Mail Snafu Shows "Selective Disclosure" Pitfalls, WALL ST. J., Oct. 11, 2000, at C1 (describing an incident concerning a mistakenly-released e-mail containing material information). This portends possible litigation expenditures, which may detract from issuer earnings.

212. See Opdyke, Stocks Hurting, supra note 206 (referring to the investor's uncertainty as to how to react in the face of a wave of negative earnings preannouncements).

An analyst naturally has the advantage: less costly access to other material, public information (measured in foregone opportunities); access to other analysts; quicker trading mechanisms; and superior understanding of issuers' technical jargon and its implications. This latter point is especially salient because an issuer need not disclose in a way that everyone understands. For an example of how analysts still have greater ability to pay the price for access to material, nonpublic information, see also Jeff D. Opdyke & Emily Nelson, Conference-Call Crunch: New S.E.C. Rule Turns Analysts' Rite Into a Hectic Affair, WALL ST. J., Oct. 31, 2000, at C1 (describing how frenzied analysts team-up to relay coverage of conference calls in adapting to Regulation FD).

213. For example, recall that employees who do not regularly communicate with securities professionals or the issuer's shareholders are not covered by Regulation FD. See supra note 149. The analyst, thus, has an option the investor realistically does not—to mine employees who rest underneath the executive level for information. Regrettably, the very distance that immunizes them from Regulation FD also reduces the information's accuracy and reliability.

214. Given these disclosures will occur during business hours, the cost of "tuning
Finally, for the individual investor, Regulation FD lowers the value of the released information. It does this because, under the regulation, the information goes from nonpublic to public in the time it takes the nation’s semistrong market to react.\footnote{See SELIGMAN, supra note 7, at 604.} Thus, any worthwhile, profitable information will be harder to find. Of course, this arrangement still will benefit those analysts who can assemble a material patchwork from immaterial swatches. But this sort of analysis requires time, effort, and skill—the analyst’s advantages that elude regulatory grasp. No regulation realistically can smother the pricing mechanism: one cannot suppress another’s willingness to pay for the advantage that comes from years of schooling or talking to employees in order to find a profit opportunity. One, however, can allow the market to work without hindrance so that its systemic benefits can be realized.

\section*{B. Regulation FD Restructures the Incentives}

By raising the price of disclosing incrementally, Regulation FD will restructure the incentives facing the issuer and analysts. Specifically, the regulation will decrease the disclosure options, leading to a diminished flow of information and market volatility.

\subsection*{1. Decreasing the Disclosure Options}

By making formal what was once informal, Regulation FD narrows the options available to issuers and analysts. Thus, these transactions will occur less frequently, and the benefits that selective disclosure formerly brought to the market will be diminished.

Now, in order to avoid the need for disclosure (or liability), an issuer’s financial officer and an analyst cannot discuss material, nonpublic information. The financial officer must consider if any material, nonpublic information (even the most marginal) is worth the costs of public disclosure.\footnote{This information ranges from important-but-nonpublic news to marginally interesting information that just passes an officer’s threshold of perceived materiality.} If such information is deemed worth it \textit{ex ante}, disclosure will follow.

Presumably, if the information merits such disclosure, an analyst’s inquiry would not be necessary. The disclosure, however, no longer will reflect the

in” for the average investor will mean reduced productivity in his or her own occupation. This implies a social loss of those services or goods, although such losses defy measurement. The rational investor, when faced with these costs and benefits, quickly would forego tuning in, and instead rely upon analysts’ recommendations and reports as before. Six-thousand letters to the SEC notwithstanding, this begs the question of Regulation FD’s usefulness.
information’s worth or materiality accurately to particular parties. Rather, it will
primarily reflect the company’s desire to avoid liability under the federal laws and
the need for companies to disclose in order to keep up with competitors’ increased
disclosures.

In the alternative, if the benefits of disclosure in any particular case—after
being offset by the costs of disclosure—are not deemed worth the price of the
SEC’s requirements, then the information remains with the company, untapped and
unused.217 Thus, analysts and researchers have an incentive to use costly searches
to uncover information that previously could have been selectively disclosed.218

Regulation FD diminishes the information flow by narrowing the ranges of
disclosed information available to the transacting parties in another way. Stymied
by an officer’s imposed silence, analysts will be more motivated to tune in with
other analysts to conference calls or similar broadcasts.219 By forcing such an
emphasis on this means of analyst-executive communication, Regulation FD
formalizes the once informal conference call, thereby increasing the costs
associated with this previously flexible disclosure device.220

For instance, the demand for conference calls likely will increase, which
means that more market participants will tune in to receive information. Without
the individual guidance that selective disclosure offered, the conference call will
become a primary source of information for the analyst. With a greater incentive
to tune in, he or she will have to assess the value of competing, simultaneous

217. Ironically, Regulation FD will bring the importance of the analyst as
middleman into sharp relief. If the interaction of Regulation FD and issuer cost
appraisals make some packets of information unreachable to the average investor,
demand will increase for the analyst’s ability to relocate disparate pieces of data in time
and space, especially as material, profitable information becomes more scarce. Of course,
Regulation FD will raise the costs of these services as material information becomes more
scarce.

218. Or analysts have an incentive to contact the officer and get the information
anyway, relying upon an impaired understanding of materiality or Regulation FD. For
some analysts, the question will not be whether the information is material and nonpublic,
but whether the financial officer thinks the information is material and nonpublic.
Administrative costs of deciding this question will include increased agency, litigation,
and monitoring costs.

219. This will not be entirely detrimental. Research shows that analysts benefit
from the opportunity to hear other analysts’ questions. Frankel et al., supra note 87, at
135. As with any input, though, this is subject to diminishing returns. With more
investors vying for answers, there will be a greater range of questions and, hence, a
greater range of relevance for investors.

220. One commentator has challenged the statutory authority of the SEC to allow
these alternative forms of disclosure as complying with disclosure rules. Conner, supra
note 171, at 254-55.
conference calls.\textsuperscript{221} Without the one-on-one interface characteristic of selective disclosure, the sacrifice of choosing one call over another is made greater given finite time and resources. Again, this narrows the options facing the parties.

Moreover, with analysts and fund managers tuning in more, there will be increased competition for answers to questions that would be queried during the one-to-one session; thus, analysts must be more discriminating about the questions they ask, whereas before they would have had more latitude in questioning.

Also, to the extent the officers do not have the answers or are unprepared, they no longer have the option of following up with the analyst. Because issuers are motivated to disclose, it follows that officers will endeavor to be more prepared for these conference calls than was required in the past. Such preparation (and the costs of such preparation) was not needed prior to Regulation FD.

In sum, Regulation FD removes the benefits that came from the flexibility of selective disclosures: low-cost disclosure for issuers, and cheap verification and clarity for efficiency-enhancing analysts. Because both of these were benefits to the investor and shareholder, they are impacted, as well.\textsuperscript{222} Instead, information will remain unaccessed and informational efficiency will be offset.

2. From Inefficiency to Volatility

Because Regulation FD poses an assortment of threats to would-be violators, it creates a fear of liability.\textsuperscript{223} By attaching liability to improper disclosures, the SEC raised the price of disclosure generally. Now, an issuer's officer must include the potential of liability when communicating with analysts. Given these higher costs, directors already have started to institute a prohibition on releasing such information: silence has become a substitute for communication to the market.\textsuperscript{224}

\textsuperscript{221} This is not an unlikely event at all given that earnings reports tend to occur during the same periods.

\textsuperscript{222} For a summary of those benefits, see \textit{supra} notes 68-83 and accompanying text.

\textsuperscript{223} See \textit{supra} notes 191-96 and accompanying text.

\textsuperscript{224} The National Investors Relations Institute announced that four months after Regulation FD was enacted twenty-four percent of companies are providing less information to the market. Opdyke, \textit{Stocks Hurting, supra} note 206.

As to those companies decreasing communication, see Robert McGough & Cassell Bryan-Low, \textit{Analysts' Earnings Estimates are Diverging, and S.E.C. Disclosure Rule May be the Reason}, \textit{Wall St. J.}, Nov. 2, 2000, at C2 (United Air Lines, Inc.); Robert McGough & Robert Guy Matthews, \textit{Clamming Up? Some See Alcoa Adopting the Silent Treatment}, \textit{Wall St. J.}, Oct. 23, 2000, at C1 (Alcoa); Opdyke, \textit{Stocks Hurting, supra} note 206 (Gillette). Other companies are also reportedly adopting such a procedure when before individual guidance on earnings and estimates was the norm. McGough &
Because an analyst will not want to incur aider and abetter status, Regulation FD overdeters. In the face of uncertainty, an analyst’s inquiries will be curbed whether or not they are legitimate. This absence of communication leaves analysts without a part of the analysis; greater inaccuracy naturally ensues. This will be especially clear in volatile industries where wider swings in the prices are the norm. Hence, variance in the analysts’ pricing of a stock will swell and interfere with fundamental efficiency.

Worse still, inability to predict results leads to surprises when corporations make earnings announcements. The market is able to absorb negative reports more smoothly when the information is introduced by analysts. However, in the wake of Regulation FD, corporations are making announcements without analysts preparing the market, resulting in sudden price dips. This type of market volatility and price oscillation skews the information available to the market, as well as to individual investors, rendering Regulation FD as regulation ad absurdum.

Matthews, supra. It is unlikely that these are just initial overreactions that will modulate as the industry adjusts because this appears to be the very type of result that Regulation FD was designed to create.

225. One analyst has stated that analysts’ models lose twenty-five percent of their accuracy without the information from companies’ selective disclosure. JeffD. Opdyke, Regulation is Altering the Way Analysts Approach Their Jobs, WALL ST. J., Oct. 23, 2000, at C1 [hereinafter Opdyke, Regulation is Altering].

226. See George J. Stigler, The Economics of Information, 69 J. POL. ECON. 213, 214 (1961) (“Price dispersion is a manifestation—and, indeed, it is the measure—of ignorance in the market.”).

An early academic study, however, has called this conclusion into question. Researchers at the business schools at the University of Southern California and Purdue University studied the effects of Regulation FD on stock-price volatility after earnings announcements. Phyllis Plitch, Dire Effects of Disclosure Rule Doubled, WALL ST. J., July 24, 2001, at C14. The study sampled sixteen-thousand companies and was based on year 2000 fourth-quarter earnings announcements. Id. The study found no increased volatility ensuing upon earnings announcements; indeed, the evidence suggested that volatility decreased after Regulation FD was enacted. Id. Others think that a longer time period is needed before Regulation FD’s net effects can be definitively stated. Id.


228. Id.

229. For the effect of Regulation FD on market prices, see Opdyke, Stocks Hurting, supra note 206; McGough & Bryan-Low, supra note 224. Analysts’ inability to make better predictions without selective disclosure is a powerful vindication of those who have said that analysts have become too reliant upon contacts with chief financial officers. Opdyke, Regulation is Altering, supra note 225. Such results suggest that, when analysts
V. CONCLUSION

All in all, Regulation FD does achieve its noble goal: individual investors will have equal access to the information analysts have been receiving. However, investors may find they do not want to incur the costs of such access. Indeed, the Supreme Court already has warned of the other, unintended results of Regulation FD: "Imposing a duty to disclose . . . because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts."230 As it was inappropriate and inefficient to bring Rule 10b-5 to bear against selective disclosure, so it is with the new disclosure requirements.

To argue against the idea of fairness is to fight a steeply uphill battle; equality of information is consonant with the nation's democratic, egalitarian notions. One's burden, however, is alleviated when what appears to be fair is revealed to be insidious. Regulation FD ostensibly benefits the investor, and in so doing, entrenches itself, while, in actuality, it subtly, remotely, but undeniably, harms market efficiency and the investor. One should hope, as does the SEC, that the renewed investor confidence will compensate.

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