

A THEORETICAL BASIS FOR SELECTIVE DISCLOSURE REGULATION

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I INTRODUCTION

The Corporations and Markets Advisory Committee ('CAMAC') in Australia is currently considering aspects of market integrity, including issues relating to closed or private corporate briefings to analysts.¹ Senator Nick Sherry, the Minister for Superannuation and Corporate Law, has asked the Committee to:

- examine the role that analysts' briefings play in Australia's financial markets, including whether their role is a positive one that leads to greater market efficiency
- advise whether changes may be required to Australia's regulatory framework and, if so, what form they should take.²

The author discusses corporate briefings and argues for policy change, including open access, in another forum.³ This article concerns the related debates on the role of analysts and regulation prohibiting selective disclosure. Selective disclosure is the disclosure of information by companies to selected investors, such as analysts, without disclosure to the wider public. There is no specific selective disclosure regulation in Australia. Company disclosures to analysts or other investors are only prohibited to the extent that they breach continuous disclosure or insider trading regulation.

There is minimal Australian legal research on the theoretical basis for selective disclosure regulation. James Cox suggests that communication between company management and analysts should not be subject to disclosure regulation because this may discourage market research, thereby reducing the market's efficiency.⁴ Similarly, Simon Rubenstein concludes that the broad scope of the equal access theory must be reconciled with the need to encourage market

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¹ Corporations and Markets Advisory Committee, *Aspects of Market Integrity: Issues Paper* (2009) 31–41.

² *Ibid* 31.

³ Gill North, 'Closed and Private Company Briefings: Justifiable or Unfair?' (2008) 26 *Company and Securities Law Journal* 501. The briefings article is cited in the Corporations and Markets Advisory Committee, 'Issues Paper', above n 1, 32–5, 39–40.

⁴ James D Cox, 'An Outsider's Perspective of Insider Trading Regulation in Australia' (1990) 12 *Sydney Law Review* 455, 467, 481. See also Ashley Black, 'The Reform of Insider Trading Law in Australia' (1992) 15(1) *University of New South Wales Law Journal* 214.

analysis and research, with exclusion from penalty for those who exercise ‘skill, acumen and diligence in their trading’.⁵ Lori Semaan, Mark Freeman and Michael Adams suggest the issue of the position of broker-analysts creates a tension between the aims of continuous disclosure and insider trading regulation. They admit that broker-analysts have the ability to ask questions that can reveal price-sensitive information, but suggest that trading on this information can assist with price efficiency.⁶ However, these comments on the role of analysts, research incentives, and efficiency are not explored further.

In contrast, the debates and empirical studies in the United States (‘US’) on selective disclosure regulation provide a rich spectrum of views on the role of analysts and selective disclosure issues. There has been vigorous debate on these topics for many decades, culminating with the introduction by the Securities and Exchange Commission (‘SEC’) of Regulation Fair Disclosure (‘Reg FD’)⁷ in 2000. The US material and experiences can usefully inform the debate in Australia. Indeed, many of the submissions to the CAMAC review touch on arguments made in the US.

Some of the selective disclosure arguments mirror those made in relation to insider trading. Some commentators argue that selective disclosure does not harm anybody. Others suggest that trading based on selectively disclosed information enhances market efficiency based on price signalling or agency theories. However, the most complex and controversial arguments are the selective disclosure theories based on analyst or research incentives.

The article argues that the theories involving privileged access by analysts and other favoured investors to company information are not compelling in contemporary markets. Listed companies are now able to disseminate information about themselves cheaply and easily using modern technologies. Information should therefore be made available to all investors on an equal basis, with competition for market out-performance based on superior analytical skills rather than on who can: get the best access to company management; win sufficient favour with the management to obtain the best information; and write sufficiently favourable reports to maintain regular access.

Ultimately, transparent corporate disclosure in the public arena is likely to be the optimal way to incentivise genuine research and independent analysis by investors, encourage healthy competition, minimise conflicts of interest, and enhance economic efficiency. A disclosure framework that emphasises and enforces equal access to information promotes genuine competition among *all* investors who are able to process, analyse and trade on company information.

⁵ Simon Rubenstein, ‘The Regulation and Prosecution of Insider Trading in Australia: Towards Civil Penalty Sanctions for Insider Trading’ (2002) 20 *Company and Securities Law Journal* 89, 93.

⁶ Lori Semaan, Mark Freeman and Michael Adams, ‘Is Insider Trading a Necessary Evil for Efficient Markets?: An International Comparative Analysis’ (1999) 17 *Company and Securities Law Journal* 220, 239.

⁷ United States Securities and Exchange Commission, *Selective Disclosure and Insider Trading, Exchange Act Release Nos 33-7881 2000 WL 1201556*. The new rules and amendments took effect on 23 October 2000.

The article is in six parts. Part II outlines and discusses the selective disclosure theories and arguments. Part III reviews Regulation Fair Disclosure in the US. Part IV provides a summary of the regulation in Australia in relation to analysts, research, access to company management, and conflicts of interest. Part V outlines relevant global and Australian specific empirical research. Part VI provides analysis and concludes.

II SELECTIVE DISCLOSURE THEORIES AND ARGUMENTS

Some of the theories and arguments on selective disclosure, including the investor harm arguments and market efficiency theories based on price signalling and agency costs, are similar to those made in relation to insider trading. In addition, there are theories specific to selective disclosure based on analyst and research incentives.

A Are Investors Harmed by Selective Disclosure?

Several scholars argue that uninformed or unsophisticated investors do not require protection from selective disclosure because they are protected by, or can free ride on, the efficiency of the market.⁸ Others suggest trading profits from selective disclosure provide compensation for professional research efforts and are not at the expense of uninformed or unsophisticated investors.⁹

However, most commentators suggest that market participants with an information advantage benefit systematically at the expense of participants without such an advantage.¹⁰ Victor Brudney points out that the history of securities legislation suggests that Congress has long sought to protect public investors from exploitation of institutional informational advantages that cannot be lawfully overcome or offset.¹¹

⁸ See Christopher Saari, 'The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry' (1977) 29 *Stanford Law Review* 1031, 1076; Frank Easterbrook and Daniel Fischel, 'Mandatory Disclosure and the Protection of Investors' (1984) 70 *Virginia Law Review* 669, 693-4; Roberta Romano, 'Empowering Investors: A Market Approach to Securities Regulation' (1998) 107 *Yale Law Journal* 2359, 2378; Christopher Donald, 'A Critique of Arguments for Mandatory Continuous Disclosure' (1999) 62 *Saskatchewan Law Review* 85, 112-15.

⁹ See, eg, Daniel Fischel, 'Insider Trading and Investment Analysts: An Economic Analysis of *Dirks v Securities and Exchange Commission*' (1984) 13 *Hofstra Law Review* 127, 146; Homer Kripke, *The SEC And Corporate Disclosure: Regulation In Search Of A Purpose* (1979) 14-16, 284-6.

¹⁰ H Nejat Seyhun, 'Insiders' Profits, Costs of Trading and Market Efficiency' (1986) 16 *Journal of Financial Economics* 189, 190. See also Robert Masson and Ananth Madhavan, 'Insider Trading and the Value of the Firm' (1991) 39 *Journal of Industrial Economics* 333, 335; Stephen Choi, 'Selective Disclosures in the Public Capital Markets' (2002) 35 *UC Davis Law Review* 533; Ian Ayres and Stephen Choi, 'Internalizing Outsider Trading' (Public Law Research Paper No 4, Yale Law School, 2001) 15; Merritt Fox, 'Regulation FD and Foreign Issuers: Globalization's Strains and Opportunities' (2001) 41 *Virginia Journal of International Law* 653, 657.

¹¹ Victor Brudney, 'Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws' (1979) 93 *Harvard Law Review* 322, 357, 360.

B Selective Disclosure and Market Efficiency

Some parties argue that trading based on selective disclosure provides price signals to the market, thereby increasing share price accuracy and market efficiency.¹² This price efficiency theory is similar to that expounded by Manne in relation to insider trading, except that the party or parties trading on selectively disclosed or private information are a person or persons outside of the company rather than company insiders. In the US, such trading is commonly referred to as outsider trading. Henry Manne argued in the 1960s that insider trading is desirable on the basis that it provides price signals to the market, thereby enhancing security pricing efficiency.¹³

The counter arguments are also similar to those made on insider trading. The dissemination of information through trading based on insider or outsider information can be a slow and noisy process.¹⁴ When such trading is permitted, all noisy and uncertain signals may result in increased speculative trading activity, leading to a reduction in share price accuracy and increased price volatility. In any event, information that is revealed through insider or outsider trading generally becomes public information soon after the trading occurs.¹⁵ Any market efficiency gains are therefore restricted to a few hours or days, with little impact, if any, on capital allocations. Thus, even if one accepts the argument that insider or outsider trading allows earlier incorporation of the relevant information into the share price and that this enhances market efficiency, economic allocations (and not merely secondary allocations or trades) that are impacted by short-term price efficiency gains may be minimal.¹⁶ Market and economic efficiency may be more effectively achieved by immediate disclosure of the information to all investors.¹⁷

¹² See, eg, Choi, above n 10, 535, 541; Ayres and Choi, above n 10, 15, 20–22; John Barry, ‘The Economics of Outside Information and Rule 10b-5’ (1981) 129 *University of Pennsylvania Law Review* 1307, 1330–4; Fox, above n 10, 660, 674. See also Paul Broutas Jr, ‘Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts’ (1992) 92 *Columbia Law Review* 1517, 1533; Donald, above n 8, 112–15.

¹³ Henry Manne, ‘In Defence of Insider Trading’ (1966) 44 *Harvard Business Review* 113. See also Henry Manne, *Insider Trading and the Stock Market* (1966) 77–158; Henry Manne, ‘Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark’ (2005) 31 *Journal of Corporation Law* 167, 185.

¹⁴ Morris Mendelson, ‘The Economics of Insider Trading Reconsidered’ (1969) 117 *University of Pennsylvania Law Review* 470, 473–6; James Cox, ‘Insider Trading and Contracting: A Critical Response to the “Chicago School”’ [1986] *Duke Law Journal* 628, 648; Saul Levmore, ‘In Defense of the Regulation of Insider Trading’ (1988) 11 *Harvard Journal of Law and Public Policy* 101, 103; Black, above n 4, 219; Kimberly Krawiec, ‘Fairness, Efficiency and Insider Trading: Deconstructing the Coin of the Realm in the Information Age’ (2001) 95 *Northwestern University Law Review* 443, 498.

¹⁵ David Pompilio, ‘On the Reach of Insider Trading Law’ (2007) 25 *Company and Securities Law Journal* 467, 472.

¹⁶ Mark Klock, ‘Mainstream Economics and the Case for Prohibiting Inside Trading’ (1994) 10 *Georgia State University Law Review* 297, 303.

¹⁷ Brudney, above n 11, 341; Joel Seligman, ‘The Reformulation of Federal Securities Law Concerning Nonpublic Information’ (1985) 73 *Georgetown Law Journal* 1083, 1119. See also Gill North, ‘Efficiency, Fairness and Irrationality: Incompatible or Complementary?’ (2009) 24 *Banking and Finance Law Review* 311; Gill North, ‘Periodic Disclosure: Enhancements to Enable All Investors to Make Informed Decisions’ (2009) 27 *Company and Securities Law Journal* 23; Gill North, ‘The Insider Trading Generally Available and Materiality Tests: Are They Achieving Their Aims?’ (2009) forthcoming *Company and Securities Law Journal*.

C Selective Disclosure as Incentive for Analysis and Research

Traditional scholarly literature suggests that analysts require the right to obtain and use private company information in return for enhancing market efficiency by the provision of genuinely independent analysis and research.¹⁸ It is often assumed that analysts do all the discovery of security related information because they have the required education, experience, resources, and economies of scale to gather, analyse and produce information efficiently.¹⁹ As such, analysts are portrayed as ‘crucial players in the mechanisms of market-place efficiency that lead to optimal allocations of capital resources.’²⁰ Individual or retail investors have access to the private information by buying the information from an intermediary or investing with a fund manager.²¹ Alternatively, they can accept the market price and free ride on the presumption of marketplace efficiency.²² The broader public are seen to benefit from the existence of analysts because the information discovered by analysts leads to more accurate or efficient security prices.²³

Some commentators also claim that selective disclosure is needed as an incentive for financial analysts to enter, or to remain in, the market.²⁴ Barry indicates that stock trading based on selective disclosures prior to the publishing of research ‘provides a just return for legitimate industry and encourages economically efficient behavior.’²⁵ Fischel suggests that ‘the explanation for hiring analysts is simple – to obtain superior information and earn abnormal positive returns.’²⁶ ‘Nobody will pay an analyst for information that he must publicly disclose before selling it to ... clients.’²⁷ Choi and Barry argue that giving persons in possession of outside information a right to trade without disclosure may preserve the necessary incentives for private analysis.²⁸ Broutas advocates the use of analysts as a filter for information to provide credibility to

¹⁸ Jill Fisch and Hillary Sale, ‘The Securities Analysts as Agent: Rethinking the Regulation of Analysts’ (2003) 88 *Iowa Law Review* 1035.

¹⁹ See, eg, Zohar Goshen and Gideon Parchomovsky, ‘The Essential Role of Securities Regulation’ (2006) 55 *Duke Law Journal* 711, 723–5; Dennis Corgill, ‘Insider Trading, Price Signals and Noisy Information’ (1996) 71 *Indiana Law Journal* 355, 397.

²⁰ Donald Langevoort, ‘Investment Analysts and the Law of Insider Trading’ (1990) 76 *Virginia Law Review* 1023, 1024.

²¹ *Ibid* 1025; Fischel, above n 9, 146; Saari, above n 8.

²² Fischel, above n 9, 146.

²³ Scott Russell, ‘Regulation Fair Disclosure: The Death of the Efficient Capital Market Hypothesis and the Birth of Herd Behavior’ (2002) 82 *Boston University Law Review* 527, 550–1. See also *Securities and Exchange Commission v Bausch & Lomb Inc*, 420 F Supp 1226, 1230 (SDNY, 1976).

²⁴ Barry, above n 12, 1353, 1387–8; Corgill, above n 19, 397–8; Stephen Choi and Eric Talley, ‘Playing Favorites with Shareholders’ (2002) 75 *Southern California Law Review* 271, 310; Choi, above n 10, 545; Broutas, above n 12, 1540; Bruce Kobayashi and Larry Ribstein, ‘Outsider Trading as an Incentive Device’ (2006) 40 *UC Davis Law Review* 21, 31.

²⁵ Barry, above n 12, 1388. Barry acknowledged that problems may arise when outside information is used for personal profit by some stock exchange professionals. See also Corgill, above n 19, 397–8, 416–17.

²⁶ Fischel, above n 9, 144.

²⁷ *Ibid* 145.

²⁸ Choi, above n 10, 544–5; Barry, above n 12, 1353.

the information and to allow the information to enter the public arena in a format that is more easily understandable by other investors.²⁹

Some companies similarly argue that they need to disseminate information privately as an incentive for analysts to produce research.³⁰ Fischel argues that the fact that companies ‘voluntarily transmit information to analysts suggests that the use of analysts is an efficient method of communicating information’.³¹ Forcing companies to disclose publicly may increase information production costs, making it more difficult to reduce any information disparity.³²

However, Ian Lee suggests ‘the argument for the necessity of speculative profits rests on untested, debatable assumptions about the absence of other incentives for investment in information’.³³ While ‘the early dissemination of information about firms and market conditions has social value, the private rewards from being the first to know are independent of, and their magnitude is not limited to, the social value of the information once it is disseminated’.³⁴ Indeed, there may be no ‘relationship between the social value of information and the private value of prior knowledge of that information. ... [P]rivate trading advantages are, at best, a haphazard means of incentivizing the production of socially valuable information.’³⁵

To the extent that company information is produced for multiple purposes, there may be a range of incentives driving the production of company information.³⁶ Analysts operate in a competitive market and incentives to discover valuable information are powerful.³⁷ In any event, the mandatory disclosure system ensures an information rich environment. Consequently, it is ‘unclear therefore how much additional positive externality-related benefits additional research beyond this level may have for the securities markets as a whole’.³⁸ ‘Having multiple analysts engaging in duplicative information research ... may not add much to the common pool of available information.’³⁹

D Agency Cost Reduction

Some scholars also argue that analysts require the guaranteed higher returns resulting from selective disclosures in return for continuous monitoring of a

²⁹ Brontas, above n 12, 1540.

³⁰ Langevoort, above n 20, 1029–31; Brontas, above n 12, 1540.

³¹ Fischel, above n 9, 144.

³² Ibid 145.

³³ Ian Lee, ‘Fairness and Insider Trading’ [2002] *Columbia Business Law Review* 119, 175.

³⁴ Ibid 178–9.

³⁵ Ibid 175.

³⁶ Krawiec, above n 14, 488. See also Harold Demsetz, ‘The Private Production of Public Goods’ (1970) 13 *Journal of Law and Economics* 293, 295; Jonathan Oever, ‘Insider Trading and the Dual Role of Information’ (1997) 106 *Yale Law Journal* 1325.

³⁷ Seligman, above n 17, 1124.

³⁸ Ayres and Choi, above n 10, 56–7.

³⁹ Ibid 55.

company. It is suggested that analysts act as unbiased market gatekeepers, resulting in lower agency costs and enhanced market efficiency.⁴⁰

However, many legal and accounting scholars question the agency and analyst efficiency claims. Selective disclosure between companies and analysts can result in biased research and reduced share price accuracy and market efficiency.⁴¹ Companies may choose to selectively disclose only to those most likely to respond with favourable company recommendations,⁴² or to those in a position to provide the company with new capital. If the relationship between a company and analysts becomes too close, company management may feel pressured to manipulate or massage the company results, or even to adjust the corporate strategy, in order to satisfy analysts' expectations or forecasts.⁴³ Analysts who issue a negative recommendation on the company, or who criticise the company, may be blacklisted or frozen out from future access to management and to company information.⁴⁴ Moreover, when management receive a large proportion of their remuneration as bonuses or stock options, selective disclosure may be used to artificially maintain or increase the share prices when this maximises personal returns.⁴⁵

Ernst Maug suggests that when trading based on selective disclosure is not regulated, 'managers and large shareholders ... form a "cozy cartel" at the expense of small shareholders'.⁴⁶ In practice, analysts and other investors who are privy to selective private information can choose to profitably trade on the information themselves, rather than, or prior to, disseminating it to the 'public'.⁴⁷ Institutions often prefer to exit when companies are in trouble rather than demanding governance changes from the management.⁴⁸ Favoured analysts or institutional recipients who are selectively forewarned of bad news can sell down in advance of other investors.⁴⁹ Even when the selectively disclosed information

⁴⁰ Stephen Thurber, 'The Insider Trading Compensation Contract as an Inducement to Monitoring by the Institutional Investor' (1994) 1 *George Mason University Law Review* 119, 134; R Charles Moyer, Robert Chatfield and Phillip Sisneros, 'Security Analyst Monitoring Activity: Agency Costs and Information Demands' (1989) 24 *Journal of Financial and Quantitative Analysis* 503; Cf John Coffee Jr, 'What Caused Enron? A Capsule Social and Economic History of the 1990s' (2003) 89 *Cornell Law Review* 269, 286–7. See also John Coffee Jr, 'Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms' (2004) 84 *Boston University Law Review* 301; John Coffee Jr, *Gatekeepers: The Professions and Corporate Governance* (2006).

⁴¹ Fox, above n 10, 657, 677; Choi, above n 10, 548.

⁴² Langevoort, above n 20, 1041; Fisch and Sale, above n 18, 1054; Brountas, above n 12, 1547; Bin Ke and Yong Yu, 'The Effect of Issuing Biased Earnings Forecasts on Analysts' Access to Management and Survival' (2006) 44 *Journal of Accounting Research* 965.

⁴³ Fisch and Sale, above n 18, 1056. See also, Coffee, 'What Caused Enron?', above n 40; Coffee, 'Gatekeepers', above n 40, 257.

⁴⁴ Langevoort, above n 20, 1042; Fisch and Sale, above n 18, 1054. See also Coffee, 'Gatekeepers', above n 40, 258.

⁴⁵ Fisch and Sale, above n 18, 1090; Brudney, above n 11, 335.

⁴⁶ Ernst Maug, 'Insider Trading Legislation and Corporate Governance' (2002) 46 *European Economic Review* 1569, 1588.

⁴⁷ Langevoort, above n 20, 1042; Fisch and Sale, above n 18, 1044.

⁴⁸ John Coffee Jr, 'Liquidity Versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 *Columbia Law Review* 1277, 1288; Fisch and Sale, above n 18, 1088; Choi, above n 10, 549, 555; Ayres and Choi, above n 10, 24.

⁴⁹ Fisch and Sale, above n 18, 1090; Choi, above n 10, 549.

is disseminated to the market in the form of research, it may be done on a preferential client basis.⁵⁰ Finally, when sell-side analyst commissions are tied to brokerage levels or investment banking revenue, this can result in pressure on analysts to produce particular recommendations in order to increase brokerage volumes or to obtain new investment banking business.⁵¹ All of these outlined conflicts of interest or biases have the potential to increase agency costs and to interfere with an efficient allocation of capital.⁵²

Empirical instances of such conflicts of interests and biases are well documented.⁵³ John Coffee Jr suggests that analysts in the US during the 1990s 'were not so much professionals as legally immune purveyors of inside information' from companies to institutions.⁵⁴ Ronald Gilson and Reinier Kraakman suggest that when they first published on the mechanisms of market efficiency, they should have been more sceptical of market institutions, their incentives, and about how well they perform their roles.⁵⁵ They indicate that they 'failed to appreciate the magnitude of the incentive problems in the core market institutions that produce, verify, and process information about corporate issuers.'⁵⁶ They admit they were naïve about the role of security analysts, particularly those on the sell-side of the market.⁵⁷

As Donald Langevoort suggests, the process of informal contacts between companies and analysts 'creates its own moral hazard problem'.⁵⁸

There are conflicts of interest inherent in the disclosure process that will on occasion interfere with the quality of investment advice produced⁵⁹ ... [U]nder many circumstances, the benefits of selective disclosure will be captured either largely or exclusively by the recipients, not the market as a whole. In these instances, ... the resemblance between such activity and ... a corporate insider is striking.⁶⁰

Notably, Langevoort concludes that the public policy of actively encouraging informal analyst contacts seems premature when so much of the profit is captured

⁵⁰ Brontas, above n 12, 1546.

⁵¹ See, eg, Coffee, 'What Caused Enron?', above n 40; Fisch and Sale, above n 18, 1045–6; Hsiou-wei Lin and Maureen F McNichols, 'Underwriting Relationships, Analysts' Earning Forecasts and Investment Recommendations' (1998) 25 *Journal of Accounting and Economics* 101, 124–5; Harrison Hong and Jeffrey Kubik, 'Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts' (2003) 58 *Journal of Finance* 313; Hamid Mehran and Rene Stulz, 'The Economics of Conflicts of Interest in Financial Institutions' (2007) 85 *Journal of Financial Economics* 267.

⁵² Langevoort, above n 20, 1025; Fisch and Sale, above n 18, 1079, 1097–8; Coffee, 'What Caused Enron?', above n 40.

⁵³ Fisch and Sale, above n 18, 1053–6; John Orcutt, 'Investor Skepticism v Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors' (2003) 81 *Denver University Law Review* 1, 26–8; Mark Westfield, *HIH: The Inside Story of Australia's Biggest Corporate Collapse* (2003); Commonwealth, HIH Royal Commission, *The Failure of HIH Insurance* (2003).

⁵⁴ Coffee, 'Gatekeepers', above n 40, 263.

⁵⁵ Ronald Gilson and Reinier Kraakman, 'The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias' (2003) 28 *Journal of Corporation Law* 715, 736–7.

⁵⁶ Gilson and Kraakman, above n 55, 736.

⁵⁷ *Ibid* 737.

⁵⁸ Langevoort, above n 20, 1044.

⁵⁹ *Ibid*.

⁶⁰ *Ibid* 1046.

privately.⁶¹ Ultimately, this is the key issue driving selective disclosure regulation, as reflected in the debate leading up to the introduction of Reg FD in the US.

III REGULATION FAIR DISCLOSURE

The courts in the US previously adopted the traditional assumptions on the role of analysts. Justice Ward indicated in *Securities and Exchange Commission v Bausch & Lomb Inc* that

[a]nalysts provide a needed service in culling and sifting available data, viewing it in light of their own knowledge of a particular industry and ultimately furnishing a distilled product in the form of reports. These analyses can then be used by both the ordinary investor and by the professional investment advisor as a basis for the decision to buy or sell a given stock. The data available to the analyst – his raw material – comes in part from published sources but must also come from communication with management.

Both the NYSE and the SEC have encouraged publicly traded companies to maintain an ‘open door’ policy towards securities analysts.⁶²

Similarly, Powell J indicated in *Dirks v Securities and Exchange Commission*⁶³ that the nature of non-public information received by analysts from corporate officers and insiders at briefings is such that this

information cannot be made simultaneously available to all of the corporation’s stock holders or the public generally ... Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses; neither corporate insiders nor analysts can be sure when the line is crossed.⁶⁴

The SEC has also highlighted the important role played by analysts. They stated *In the Matter of Raymond L Dirks*⁶⁵ that ‘[t]he value to the entire market of [analysts’] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analysts’ work redounds to the benefit of all investors’.⁶⁶ Moreover, during the Reg FD consultation period, the SEC confirmed that analysts serve a screening function for technical financial information and that ‘benefits may flow to the markets from the legitimate efforts of securities analysts ... based on their superior diligence and acumen’.⁶⁷

⁶¹ Ibid 1045, 1048–9.

⁶² *Securities and Exchange Commission v Bausch & Lomb Inc*, 420 F Supp 1226, 1230 (SDNY, 1976). Justice Ward held that the SEC had not disclosed material, non-public information to securities analysts during interviews. Although the Chairman released an earnings estimate to securities analysts and disclosed material, non-public corporate information, the act was an ‘uncharacteristic and inadvertent’ slip which was unaccompanied by the requisite *scienter*.

⁶³ 463 US 646 (1983).

⁶⁴ Ibid 659. The judgment by Powell J represented the majority view.

⁶⁵ SEC Lexis 2213 (1981).

⁶⁶ Ibid. This paragraph is cited by Powell J in *Dirks v Securities and Exchange Commission*, 463 US 646, 659 (1983).

⁶⁷ United States Securities and Exchange Commission, *Proposed Rule: Selective Disclosure and Insider Trading* (2000).

Nevertheless, the SEC indicated that selective disclosure from companies to favoured analysts impacts on the principles of integrity and transparency and undermines the fundamental principle of fairness;⁶⁸ can lead to potential conflicts of interest further impacting the confidence of investors; and can undermine the independence of analyst reporting leading to incentives to delay public disclosure and to manipulate earnings and expectations.⁶⁹ It argued that advances in technology had reduced the importance of analysts as information intermediaries, and made it easier and less costly for issuers to disseminate information directly to the public.⁷⁰

The SEC proposed Reg FD in 2000 to ensure equal access to information for all investors and to deter selective disclosure of company information. It was hoped that the regulation would level the playing field and take away the advantages that analysts and others with privileged access to companies enjoyed relative to other investors.

The SEC posited that Reg FD would result in:

- more open disclosure practices and increased investor confidence in the integrity of the market, with a consequential lowering in capital costs;
- an improvement in the information provided to the marketplace, because of enhanced direct company disclosure to the market or improved analyst performance;
- genuine competition among analysts, with performance measured on ability and effort rather than favoured access to company management; and
- independent analyst reporting without company access consequences.⁷¹

It suggested that while the New York Stock Exchange ('NYSE') and National Association of Securities Dealers ('NASD') required listed companies to promptly disclose material information, companies still retained some control over the release, timing, audience, and forum of many important disclosures.

Arthur Levitt, the Chairman of the SEC, indicated that '[q]uality information is the lifeblood of strong, vibrant markets ... [and] is at the very core of investor confidence'.⁷² He suggested that the 'all-too-common' and 'insidious practice of selective disclosure' impacts on the principles of integrity and transparency and 'undermines the fundamental principle of fairness'⁷³ because the recipients of the selective disclosure and their clients are able to profit at the expense of the general public. Selective or favoured disclosure by companies to analysts can

⁶⁸ Arthur Levitt, 'Audit Committee Oversight, Selective Disclosure, and Insider Trading' (Statement delivered at the Open Commission Meeting, United States Securities and Exchange Commission, 15 December 1999) <<http://www.sec.gov/news/extra/alsdisc.htm>> at 26 April 2009; United States Securities and Exchange Commission, 'Final Rule', *Selective Disclosure and Insider Trading* (2000).

⁶⁹ United States Securities and Exchange Commission, *Final Rule: Selective Disclosure and Insider Trading* (2000).

⁷⁰ *Ibid.*

⁷¹ *Ibid.*

⁷² Levitt, above n 68.

⁷³ *Ibid.* See also United States Securities and Exchange Commission, 'Final Rule', above n 69.

also lead to potential conflicts of interest, further impacting the confidence of investors. When the independence of analyst reporting is undermined, this can lead to incentives to delay public disclosure and to manipulate earnings and expectations.⁷⁴

The SEC received 6000 public submissions or responses to the Reg FD proposal, most of which were from individual or retail investors.

A Arguments Supporting Regulation Fair Disclosure

Retail investors responded enthusiastically to the Reg FD proposal. Many expressed a strong desire to compete fairly and directly with institutional investors and an unwillingness to invest through intermediaries.⁷⁵ A submission from Tim Beyers stated that:

I've never picked a stock on the basis of an analyst recommendation or report. ... I take serious offense with the notion that I can't make an intelligent investment choice without first contacting a professional. ... Let analysts make their money as 'analysts' – interpreters of data – rather than as gatekeepers of it, as they mostly do today.⁷⁶

Larry Connolly indicated that

[a]nalytsts usually issue upgrades (downgrades) after good news (bad news) has been announced and is reflected in the companies' stock prices. I have been the chief accountant at a mid-sized publicly held company where I have seen certain analysts being 'schmoozed' by top management.⁷⁷

David Dieckelman suggested that the

vast majority of ... analysts probably have no more or less business education that [sic] many of the general public who would use this information ... In the long run, if the analysts are more efficient, we will all come back!⁷⁸

Kevin Corbin argued that '[t]oday's investing marketplace is quite different from what we previously had. ... The practice of companies disclosing information to select analysts in closed meetings is an anathema to the open flow of information.'⁷⁹

B Arguments Opposing Regulation Fair Disclosure

In contrast, industry response to the proposed regulations was very negative. A number of commentators suggested the only evidence provided by the SEC was anecdotal.⁸⁰ Many critics argued that the regulation would lead to a

⁷⁴ United States Securities and Exchange Commission, 'Final Rule', above n 69.

⁷⁵ United States Securities and Exchange Commission, *Comments of 50 Individuals Received* (2000) <<http://www.sec.gov/rules/proposed/s73199/0420b01w.htm>> at 26 April 2009.

⁷⁶ Ibid Submission from Tim Beyers.

⁷⁷ Ibid Submission from Larry Connolly.

⁷⁸ Ibid Submission from David Dieckelman.

⁷⁹ Ibid Submission from Kevin Corbin.

⁸⁰ Russell, above n 23, 536; Brian Barry, 'The Securities and Exchange Commission's Regulation Fair Disclosure: Parity of Information or Parody of Information?' (2002) 56 *University of Miami Law Review* 645, 650, 661. The SEC cited a 1998 study by the National Investor Relations Institute ('NIRI') in which 26 per cent of responding companies confirmed that they engage in some type of selective disclosure practices.

reduction in information flow from companies, commonly referred to as the chill effect,⁸¹ and increased price volatility. Brokers submitted that a decrease in information flow would result in more dramatic stock price movements upon the public release of earnings or earnings-related news and a shorter term focus by investors.⁸² Some parties suggested that efficient markets would be replaced by ‘herd behaviour’, in which irrational retail investors would either speculate madly or free ride informed investors.⁸³ Lawyers pointed out that companies would have to make difficult decisions on what information is material on a real-time basis.⁸⁴

Other critics suggested that private meetings are required for nuanced communication and for the airing of difficult or confidential topics and questions.⁸⁵ It was argued that companies would hold public meetings or conference calls with watered down or scripted disclosures.⁸⁶ In addition, companies would not be able to monitor and control market expectations through private discussion with analysts, and as a result, analyst forecasts would be less accurate and more dispersed.⁸⁷ The Securities Industry Association argued that analysts should be able to ferret out information on behalf of investors.⁸⁸ It was also suggested that individual analysts would no longer be able to distinguish themselves.⁸⁹

C Regulation Fair Disclosure Outcome

The SEC board voted three to one in favour of Reg FD and the new law took effect on 23 October 2000. However, the final rule adopted was substantially modified in response to the many submissions received. Reg FD only applies to communications to securities market professionals and to any holder of the issuer’s securities under circumstances in which it is reasonably foreseeable that the security holder will trade on the basis of the information. The issuer personnel subject to Reg FD are senior officials and those persons who regularly communicate with securities market professionals or with security holders.⁹⁰

81 United States Securities and Exchange Commission, ‘Final Rule’, above n 69; Russell, above n 23, 536; Linda Yi, ‘Road Shows on the Internet: Taking Individual Investors for a Ride on the Information Highway’ (2002) 52 *Duke Law Journal* 243, 263–8; Barry, above n 80, 662.

82 Russell, above n 23, 542; Yi, above n 81, 257–8.

83 *Ibid* 551.

84 SEC, above n 67; Russell, above n 23, 539.

85 Russell, above n 23, 542.

86 Yi, above n 81, 268–70.

87 Barry, above n 80, 662.

88 See, eg, T Andrew Eckstein, ‘The SEC’s New Regulation FD: A Return to the Parity Theory’ (2001) 69 *University of Cincinnati Law Review* 1289, 1300–1.

89 *Ibid* 1301.

90 Reg FD does not establish a duty under Rule 10b-5’s insider trading laws. Liability under Reg FD only arises when an issuer’s personnel either knows, or is reckless in not knowing that the information he or she is communicating is both material and non-public. A violation of Reg FD does not result in an issuer’s loss of eligibility to use short-form registration for a securities offering. Communications made in connection with most securities offerings registered under the *Securities Exchange Act*, 15 USC § 78a (1934) (*‘Securities Exchange Act’*) are exempt from the scope of Reg FD. Foreign governments and foreign private issuers are also outside of the scope of Reg FD: United States Securities and Exchange Commission, ‘Final Rule’, above n 69.

Failures by issuers to comply with Reg FD may be subject to an SEC enforcement action under the regulation and sections 13(a) or 15(d) of the *Securities Exchange Act*.⁹¹ The SEC may bring an administrative action seeking a cease-and-desist order, or a civil action seeking an injunction and/or civil penalties.⁹²

In summary, Reg FD requires that when a company chooses to disclose material information, the information must be disclosed broadly to the investing public, and not selectively to a favoured few.⁹³ Companies, or those acting on the company's behalf, are prohibited from selectively disclosing material non-public information to securities industry professionals, institutional investors, and specified other persons. Reg FD applies to closed-door meetings, conference calls with analysts,⁹⁴ and any situations where material information is communicated, verbally or in writing.

Commissioner Laura Unger voted against Reg FD because it interfered with 'the longstanding relationship between issuers and their analysts – a liaison that has never been particularly easy'.⁹⁵ She highlighted the benefits of having analysts 'ferret out and analyze'⁹⁶ information and the provision of reports to investors that explain the information after digesting it and putting it into context.⁹⁷ She suggested that 'investors will now be forced to perform the role previously played by analysts'.⁹⁸

Unger agreed that trading by analysts or institutional investors on information selectively disclosed during closed analyst calls, or at corporate meetings, is offensive or even illegal. However, she thought that Reg FD went too far in requiring all material information disclosed to analysts to be made public.⁹⁹ She was concerned that investors would not be able to process the information disclosed during webcasts or conference calls and that companies would reduce both their level and quality of disclosure.¹⁰⁰

Unger indicated that while she was all for the disclosure of more meaningful information, the SEC's mandate was not to ensure parity of information. She suggested that a better approach to preserve the integrity of the market would

91 United States Securities and Exchange Commission, 'Final Rule', above n 69.

92 The SEC may also bring an enforcement action against an individual at the issuer responsible for the violation, either as 'a cause of' the violation in a cease-and-desist proceeding or as an aider and abetter of the violation in an injunction action.

93 Ibid.

94 The courts in the United States have ruled that conference calls with analysts that have been recorded and transcribed are admissible as evidence: *Wenger v Lumisys, Inc*, 2 F Supp 2d 1231 (ND Cal, 1998).

95 Laura Unger, 'Fallout from Regulation FD: Has the SEC Finally Cut the Tightrope?' (Speech delivered at the Glasser LegalWorks Conference on SEC Regulation FD, New York, 27 October 2000) <<http://www.sec.gov/news/speech/spch421.htm>> at 26 April 2009, citing *Dirks v SEC*, 463 US 646 (1983). Unger also referred to the court's description of the relationship between companies and analysts as a 'fencing match conducted on a tightrope' in *Securities and Exchange Commission v Bausch & Lomb Inc*, 565 F 2d 8 (2nd Cir, 1977).

96 Ibid.

97 Ibid, citing United States Securities and Exchange Commission, *Aircraft Carrier Release* (1998).

98 Ibid.

99 Ibid.

100 Ibid. Unger pointed out that companies were voluntarily opening up their corporate communications to the public.

have been to curtail trading based on selective disclosure. Unger's view on the likely effectiveness of the Reg FD was unequivocal. She bet her house on it not working.¹⁰¹ Unger pledged to monitor the consequences of Reg FD, including any 'chilling effect', market volatility, and any disproportionate effect on smaller companies. She also promised to scrutinise enforcement of Reg FD to ensure it was applied fairly and judiciously, and she indicated that she would make sure that it did not discourage the use of technology, such as conference calls, as a means of public dissemination.¹⁰²

Empirical research relating to Reg FD is outlined in Part V. Discussion on studies that specifically examine open access conference calls is also provided.

IV SELECTIVE DISCLOSURE IN AUSTRALIA

There is no specific selective disclosure regulation in Australia. Company disclosures to analysts or other investors are only prohibited to the extent that they breach continuous disclosure or insider trading regulation. It is not possible to address continuous disclosure and insider trading related issues adequately within this article. This Part seeks only to provide a brief summary of Australian regulation in relation to analysts, research, access to company management, and conflicts of interest.

The Royal Commission Report in Australia into the failure of HIH Insurance Ltd highlighted a variety of conflicts of interests that were ignored by company management and third parties.¹⁰³ For instance, the handful of analysts who publicly criticised HIH, or placed a sell recommendation on the stock, were frozen out from any further contact with the company.¹⁰⁴ Justice Owen, the Chairman of the Commission, made a series of recommendations, including a ban on the practice of blacklisting in order to minimise potential conflicts of interest and to improve corporate transparency and management accountability.¹⁰⁵

ASX Guidance Note 8 suggests that blacklisting of 'qualified' analysts, or the provision of favoured treatment to some analysts, is inappropriate.¹⁰⁶ However, it is not clear what constitutes a qualified analyst under this guidance, particularly when private or closed briefings in Australia generally encompass all institutional investors and not only sell-side analysts. Moreover, there are no remedies for blacklisted analysts.

¹⁰¹ Ibid.

¹⁰² Ibid.

¹⁰³ HIH Royal Commission, above n 53.

¹⁰⁴ Ibid vol 1, pt 3, 72–3; Westfield, above n 53, 135.

¹⁰⁵ HIH Royal Commission, above n 53, vol 1, pt 3, 72–3, Recommendation 46.

¹⁰⁶ Australian Stock Exchange, *Guidance Note 8 – Continuous Disclosure: Listing Rule 3.1* (2005) [62]. Guidance Note 8 indicates that it is inappropriate for entities to 'blacklist' or exclude analyst with the purpose of minimising or eliminating reasonable opportunities for qualified analysts to ask relevant questions of the entity in relation to publicly available information. Similarly, it is inappropriate for entities to extend more favourable treatment and access to a select group of analysts.

Most other potential or actual conflicts of interest between companies and analysts and research independence issues in Australia are regulated through ASIC policy papers and disclosure requirements.¹⁰⁷ Empirical research on some of these issues is outlined in the next Part.

V SELECTIVE DISCLOSURE EMPIRICAL RESEARCH

Empirical research on selective disclosure is inherently limited because of the private nature of the events involved. It is very difficult, if not impossible, to precisely measure the extent of selective disclosure in a market or the net efficiency of selective disclosure regulation. Nevertheless, the empirical studies on a combined basis provide useful pointers on selective disclosure issues and the impact of selective disclosure regulation.

One body of work encompasses surveys and interviews that gather and analyse views on the level and extent of selective disclosure occurring. Other studies measure specified variables in the periods before and after the introduction of Reg FD. There is also research that examines institutional investors as effective corporate monitors and analyst conflicts of interest.

A International Research

1 Regulation Fair Disclosure (United States)

In April 2001, a roundtable review of Reg FD was held. Analysts indicated that the quality of corporate information had reduced dramatically and some argued that pricing had become more volatile. However, independent empirical studies suggest these views may have been overstated.

The National Investor Relations Institute ('NIRI') and Pricewaterhouse Coopers carried out company surveys on the impact of Reg FD on information disclosure.¹⁰⁸ In both of these surveys, about half of the company respondents indicated that Reg FD had not impacted their disclosure practices or share price volatility, with the remaining respondents split almost evenly between increases and decreases in disclosure.¹⁰⁹

¹⁰⁷ Australian Securities and Investments Commission, *Consultation Paper 46 – Licensing: Managing Conflicts of Interest* (2003); Australian Securities and Investments Commission, *Regulatory Guide 79 – Managing Conflicts of Interest: A Guide for Research Report Providers* (2004). Page 49 of the 2003 document and p 19 of the 2004 document indicate that research report providers should disclose the extent to which they have or are likely in the future to have an interest in financial products that are the subject of the report, or the extent to which they are likely to receive any benefits from the report. See also, Australian Securities and Investments Commission, *Consultation Paper 73 – Managing Conflicts of Interest in the Financial Services Industry* (2006). The consultation paper uses hypothetical case studies illustrating real or perceived conflicts of interest to explain ASIC's views on how these conflicts should be managed. Section A of the paper concerns research report providers.

¹⁰⁸ National Investor Relations Institute, 'National Investor Relation Institute Releases Survey Result on the Impact of SEC Regulation Fair Disclosure' (Press Release, 2 July 2001); Jennifer Francis, Dhananjay Nanda and Xin Wang, 'Re-examining the Effects of Regulation Fair Disclosure Using Foreign Listed Firms to Control for Concurrent Shocks' (2006) 41 *Journal of Accounting and Economics* 271, 275 fn 6.

¹⁰⁹ National Investor Relations Institute, above n 108; Francis, Nanda and Wang, above n 108.

There are many scholarly accounting and finance studies based on Reg FD. It is difficult to summarise this body of work as the studies examine a wide range of market variables and incorporate a variety of assumptions. However, Armando Gomes, Gary Gorton and Leonardo Madureira suggest there is a consensus in the academic literature that the quantity of voluntary company disclosures increased after Reg FD.¹¹⁰

2 Other International Studies

(a) Selective Disclosure

Studies in the US have specifically examined conference calls as a disclosure medium. A NIRI survey in 2000 indicated that 99 per cent of the respondent listed companies had opened up their conference calls to all investors.¹¹¹ Chun Lee, Leonard Rosenthal and Kimberly Gleason found that the quantity of information post Reg FD, as measured by the number of conference calls and the number of companies hosting conference calls, dramatically increased, with no significant consequential increase in volatility.¹¹² Dawn Matsumoto, Maarten Pronk and Erik Roelofsen suggested that conference call presentations are not 'boiler plate' disclosure. Rather they allow analysts to uncover information on the performance and the quality of the earnings signal, resulting in a richer information environment than would otherwise exist.¹¹³ Robert Bowen, Angela Davis and Dawn Matsumoto inferred that conference calls increase the total information available about a company and suggested that conference calls may present a selective disclosure problem if the public is not privy to these calls.¹¹⁴ Stephen Brown, Stephen Hillegeist and Kin Lo argued that companies that regularly hold conference calls experience sustained reductions in information asymmetry. They suggested these companies have lower costs of capital based on prior studies that link reductions in information asymmetry to lower costs of capital.¹¹⁵

¹¹⁰ Armando Gomes, Gary Gorton and Leonardo Madureira, 'SEC Regulation Fair Disclosure, Information and the Cost of Capital' (Working Paper, Case Western Reserve University, 2006) 3.

¹¹¹ National Investor Relations Institute, 'Most Corporate Conference Calls Are Now Open to Individual Investors and the Media' (Press Release, 29 February 2000).

¹¹² Chun Lee, Leonard Rosenthal and Kimberly Gleason, 'Effect of Regulation FD on Asymmetric Information' (2004) 60 *Financial Analysts Journal* 79, 87. See also Brian Bushee, Dawn Matsumoto and Gregory Miller, 'Managerial and Investor Responses to Disclosure Regulation: The Case of Reg FD and Conference Calls' (2004) 79 *Accounting Review* 617, 625, 627–8, 641.

¹¹³ Dawn Matsumoto, Maarten Pronk and Erik Roelofsen, 'Managerial Disclosure vs Analyst Inquiry: An Empirical Investigation of the Presentation and Discussion Portions of Earnings-Related Conference Calls' (Working Paper, 2006) 32. See also Richard Frankel, Marilyn Johnson and Douglas Skinner, 'An Empirical Examination of Conference Calls as a Voluntary Disclosure Medium' (1999) 37 *Journal of Accounting Research* 133.

¹¹⁴ Robert Bowen, Angela Davis and Dawn Matsumoto, 'Do Conference Calls Affect Analysts' Forecasts?' (2002) 77 *Accounting Review* 285, 313. See also William Mayew, 'Evidence of Management Discrimination Among Analysts During Earnings Conference Calls' (2008) 46 *Journal of Accounting Research* 627.

¹¹⁵ Stephen Brown, Stephen A Hillegeist and Kin Lo, 'Conference Calls and Information Asymmetry' (2004) 37 *Journal of Accounting and Economics* 343. Information asymmetry is said to exist 'when investors are differentially informed about a firm's value ... [allowing] investors with superior information to trade profitably at the expense of other investors': at 345–6.

A study by John Holland of listed companies in the United Kingdom concluded that selective or private voluntary disclosure dominates public voluntary disclosure.¹¹⁶ Holland argued that public disclosure is only made to the point where it is thought 'sufficient to legitimise additional private disclosure around the same public information disclosure, to satisfy external communication benchmarks and legal requirements and where it also satisfies the executive's need for liquidity and costs of capital benefits'.¹¹⁷ He suggested that companies were 'aware that fund managers and analysts sought a unique information advantage and that there was no point to the private meeting[s] unless this occurred'.¹¹⁸

(b) *Conflicts of Interest*

Reuters conducted a survey in the US on the consequences of analysts' making 'sell' recommendations. Eighty-eight per cent of the sell-side analysts responded that one of the consequences was exclusion from stock offerings and merger deals and 54 per cent indicated exclusion from company briefings.¹¹⁹

Official investigations during 2001–03 found that retail investors in the US were being systematically harmed by tainted investment advice.¹²⁰ Gus de Franco, Hai Lu and Florin Vasvari estimated the losses resulting from misleading analyst behaviour were primarily borne by retail or individual investors.¹²¹ Such evidence prompted the introduction of new regulation requiring:¹²² clear

¹¹⁶ John Holland, 'Private Voluntary Disclosure, Financial Intermediation and Market Efficiency' (1998) 25 *Journal of Business Finance and Accounting* 29, 63.

¹¹⁷ *Ibid* 63–4.

¹¹⁸ John Holland, *A Model of Corporate Financial Communications* (2006) 20.

¹¹⁹ Scott Findlay and Prem Mathew, 'An Examination of the Differential Impact of Regulation FD on Analysts' Forecast Accuracy' (2006) 41 *Financial Review* 9, 10 fn 2.

¹²⁰ Evidence to Committee on Financial Services, United States House of Representatives, Washington DC, 31 July 2001 (Laura Unger); Eliot Spitzer, 'The "Global Resolution" of Wall Street Investigations' (Press Release, 28 April 2003). Unger indicated that the line between research and investment banking was badly blurred. Analysts' relationships with the companies they followed were cozy. There was use of 'booster shot' research reports close to the expiration of lock-up periods, stock ownership in covered companies by sell-side analysts and other employees of the brokerage firms, and selling of this stock while the analyst maintained a 'buy' rating. See also Paul Mahoney, 'Manager-Investor Conflicts in Mutual Funds' (2004) 18 *Journal of Economic Perspectives* 161; Orcutt, above n 53, 26–8.

¹²¹ Gus de Franco, Hai Lu and Florin P Vasvari, 'Wealth Transfer Effects of Analysts' Misleading Behavior' (2007) 45 *Journal of Accounting Research* 71, 104. Franco, Lu and Vasvari estimate that actively trading individual investors lost \$2.2 billion, about two and half times the amount lost by institutions.

¹²² The four major regulatory actions were:

Section 501 in the *Sarbanes-Oxley Act 2002* governing analysts' conflicts of interest;

New analyst independence rules by the National Association of Securities Dealers ('NASD') and the New York Stock Exchange ('NYSE')

The enactment of Regulation Analyst Certification ('Reg AC'); and

A global settlement with leading investment banks.

Section 501 of the *Sarbanes-Oxley Act*, codified as s 15D of the *Securities Exchange Act* of 1934, required the SEC to adopt rules, directly or indirectly, to address analyst conflicts of interest. The NYSE and the NASD are self-regulated organisations that are subject to oversight by the SEC. New analyst independence rules were adopted by the NASD and NYSE.

separation of the research and investment banking divisions at firms;¹²³ restricted personal trading by analysts in the companies covered; analyst certification;¹²⁴ and mechanisms for providing free independent research and transparency of analyst rating information.¹²⁵

Richard Frankel, S P Kothari and Joseph Weber suggested that

[a]nalyist incentives to misinform, combined with mounting evidence of market inefficiency with respect to analyst reports ... implies analyst research cannot be unambiguously interpreted as serving to enhance informational efficiency of the capital markets.¹²⁶

Empirical evidence also suggests that institutional investors may not be the only, or indeed the most effective, corporate monitors.¹²⁷ For instance, Brian Bushee and Theodore Goodman found evidence suggesting that changes in ownership by institutions with large positions in a company were consistent with informed trading or private information. This informed trading was most evident in small companies and when large positions were taken by investment advisors and by large institutions.¹²⁸

3 Australian Research

(a) Selective Disclosure

Empirical research in Australia on selective disclosure includes studies examining the efficacy of continuous disclosure and insider trading regulation. Many of these studies suggest or imply a significant level of selective disclosure,

¹²³ The NASD and NYSE adopted rules that require analyst compensation to be determined on criteria without any consideration given to service or contribution to an investment banking division. Investment banking staff may not: influence or control analyst compensation; review or discuss pending research reports; tie analyst compensation to investment banking business; or influence analyst coverage decisions: NASD Rules 2711(b)(1)(2), 2711(d)(1)(2); NYSE Rules 472(b)(1)(2) (1)(2), 472(h)(1)(2). In addition, analysts may not solicit investment-banking business, may not participate in road shows and may not offer favourable research in return for business. In turn, companies may not retaliate against analysts who issue unfavourable research or ratings: NASD Rules 2711(c)(4), 2711(e)(j); NYSE Rule 472(b)(5), 472(g)(1)(2). Other measures included a ban on IPO spinning and preferential access to stock allocations; the appointment of independent monitors; and investor education programmes.

¹²⁴ Regulation Analyst Certification ('Regulation AC') requires a certification by an analyst of a research report of the views expressed. Analysts must certify that they agree with their own recommendations: United States Securities and Exchange Commission, *Regulation Analyst Certification Securities Act Release 33-8193* (2003).

¹²⁵ Certain research reports by investment banks have to be made public within 90 days after the end of a quarter, allowing public analysis of such research. In addition, ten investment banks paid a collective US\$1.3875 billion dollars under the global settlement: United States Securities and Exchange Commission, 'Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking' (Press Release, 28 April 2003) <<http://www.sec.gov/news/press/2003-54.htm>> at 21 May 2009.

¹²⁶ Richard Frankel, S P Kothari and Joseph Weber, 'Determinants of the Informativeness of Analyst Research' (2006) 41 *Journal of Accounting and Economics* 29, 33.

¹²⁷ Bipin Ajinkya, Sanjeev Bhojraj and Partha Sengupta, 'The Association between Outside Directors, Institutional Investors and the Properties of Management Earnings Forecasts' (2005) 43 *Journal of Accounting Research* 343; Jana Fidrmuc, Marc Goergen and Luc Renneboog, 'Insider Trading, News Releases, and Ownership Concentration' (2006) 61 *Journal of Finance* 2931.

¹²⁸ Brian Bushee and Theodore Goodman, 'Which Institutional Investors Trade Based on Private Information About Earnings and Returns?' (2007) 45 *Journal of Accounting Research* 289, 317-18.

but the periods examined are somewhat dated. More up-to-date evidence is expected within the next year or so. For example, the author is completing an empirical study on the extent to which listed Australian companies complied or otherwise during the 2007 and 2008 financial years with regulatory guidance on continuous disclosure of earnings expectations.¹²⁹

(b) Conflicts of Interest

Analysts from Goldman Sachs JB in Australia recently admitted that analysts 'seek to curry favour with management in order to preserve their information networks'.¹³⁰ They also confirmed that analysts manage their reputational risks by engaging in herding behaviour.¹³¹

In addition, empirical research on Australian sell-side broker research suggests that dissemination is done on a client-rank basis, with retail investors typically at the bottom of the hierarchy. Michael Aitken, Jayaram Muthuswamy and Kathryn Wong found that abnormal trade volumes and returns began many days prior to the official release of broker buy and sell recommendations. This finding could be explained as brokers being reactive in making their recommendations, or as the release of the recommendations to privileged clients first.¹³² The study authors suggested that the only investors who benefited economically from the broker recommendations were those whose transactions costs were minimal, and who had access to the recommendations prior to their official release or who were able to act within hours of the release of the recommendation.¹³³

Kingsley Fong et al also suggested that brokers pass their best and most timely information to their largest clients first in order to generate higher returns for fund managers who are active enough to rank as a broker's 'best client'. The information was only disseminated to smaller clients later.¹³⁴ Similarly, Howard Chan, Rob Brown and Yew Kee Ho found evidence consistent with leakage of the Australian broker recommendations prior to their 'official' release.¹³⁵

Notably, in the Aitken, Muthuswamy and Wong study, trading activity was abnormally high during the broker recommendation periods, suggesting that the recommendations generated business for the brokers. Buy and hold recommendations resulted in higher average market shares for the recommending

¹²⁹ Australian Stock Exchange, *Guidance Note 8 – Continuous Disclosure Listing Rule 3.1*, above n 106, 19.

¹³⁰ Alan Kohler, 'Secrets and Lies', *Business Spectator* (Melbourne), 2 December 2008, <<http://www.businessspectator.com.au/bs.nsf/Article/Secrets-and-lies-LWRDP?OpenDocument&src=srch>> at 27 April 2009.

¹³¹ Ibid.

¹³² Michael Aitken, Jayaram Muthuswamy and Kathryn Wong, 'The Impact of Brokers' Recommendations: Australian Evidence' (Working Paper, University of Sydney, 2000) 1, 21.

¹³³ Ibid 17.

¹³⁴ Kingsley Fong et al, 'A Closer Examination of Investment Manager Herding Behaviour (Working Paper, University of New South Wales, 2004).

¹³⁵ Howard Chan, Rob Brown and Yew Kee Ho, 'Initiation of Analyst Coverage: Does It Add Value?' (Working Paper, Monash University, 20 May 2003) 14.

broker, while sell recommendations resulted in a lower market share.¹³⁶ This finding may explain the natural bias towards optimistic broker reports. A study by the *Australian Financial Review* and the Institutional Brokers Estimate System ('IBES') found that of the analyst recommendations from Australia's largest brokers, 44 per cent were 'buy', 44 per cent were 'hold' and only 6.3 per cent were 'sell'.¹³⁷

VI SELECTIVE DISCLOSURE ANALYSIS AND CONCLUSION

[S]elective disclosure is inimical to a belief that a level playing field exists, as well as to its existence in fact: Lindgren J in *Australian Securities and Investments Commission v Southcorp Ltd (No 2)*.¹³⁸

Most traditional academic material categorises stock market investors as institutional or retail. Commentators generally assume that all institutional investors are sophisticated, professional, informed and rational, and all retail investors are poorly informed and irrational 'widows and orphans' or 'mums and dads'.¹³⁹ It is often further assumed that investment analysts do all of the discovery of security related information on the basis that retail investors do not have the required education, experience, resources, and economies of scale to gather, analyse and produce information efficiently.¹⁴⁰ In other words, retail investors require professional analysts to interpret company information and present it to them in a way that can be understood.¹⁴¹ Retail investors may obtain the benefits of any private or selectively disclosed information by purchasing the analyst reports, investing with fund managers, or by trading at the market price and free riding on the presumption of market efficiency.

Based on these assumptions, many academics and the courts view analysts as 'crucial players in the mechanisms of market place efficiency that lead to optimal allocations of capital resources'.¹⁴² The public is seen as benefiting from the existence of analysts because the information discovered by analysts leads to more accurate or efficient security prices.¹⁴³

However, some of these assumptions on the roles of market participants are unduly simplistic or are no longer valid within contemporary markets.

A Excluded Investors Are Protected by Market Efficiency?

The arguments that expressly or impliedly suggest that retail investors can free ride on the back of institutional investors, or are protected from insider

¹³⁶ Aitken, Muthuswamy and Wong, above n 132, 1, 16, 19, 21. Buy recommendations generate more brokerage and apply to more investors than sell recommendations. Sell recommendations may also be viewed negatively by the relevant companies.

¹³⁷ David Uren, *The Transparent Corporation* (2003) 60.
¹³⁸ (2003) 130 FCR 406.

¹³⁹ Russell, above n 23, 550–1.

¹⁴⁰ See, eg. Goshen and Parchomovsky, above n 19, 723–5; Corgill, above n 19.

¹⁴¹ Russell, above n 23, 551; Yi, above n 81, 261.

¹⁴² Langevoort, above n 20.

¹⁴³ *In the Matter of Raymond L Dirks*, SEC Lexis 2213 (1981).

trading or selective disclosure because of market efficiency, require further explanation to be credible. When only a few market participants have valuable private information, the resulting price signal is noisy and the absorption of news into share prices is relatively slow.¹⁴⁴ It generally takes a period of time for share prices to incorporate new information, and during this period, uninformed investors are generally not able to distinguish between trading volume and price movement based on credible private information, and trading on an uninformed basis. The argument that outsider trading enhances market efficiency assumes, first, that such trading provides effective price signalling to the market; secondly, this price signalling is the most efficient mechanism for incorporating the relevant information within the share price; and thirdly, this short-term informational or price efficiency optimises market wide efficiency. For the price signalling argument to apply to an economic efficiency goal, the price signals must impact on the allocation of real capital.

Market participants are not generally able to accurately predict the effects of their own actions or forecast the decisions of others.¹⁴⁵ There is no mechanism for Australian investors to know how other parties arrive at their decision, or indeed whether another party is better informed. Share prices in Australia generally reflect the aggregated trading position of investors who may have traded based on different information sets. Consequently, when investors trade on valuable private information that has been selectively disclosed, uninformed investors are often not protected by the market price.

The price efficiency argument is even less credible when parties simultaneously argue that retail investors are protected by market efficiency, and that institutional investors, including analysts, require selective disclosure as incentive to produce research. The mathematics of the assertion that a trade resulting from information that has been selectively disclosed produces a gain for the party with the private information, but that other investors do not make a corresponding loss, simply does not add up.¹⁴⁶

B Selective Disclosure as Analysis and Research Incentive

The argument that selective disclosure to favoured investors is necessary as incentive to analysts to produce research, which in turn is necessary to enhance economic efficiency, is also tenuous. The relationships or links between access to company information, selective disclosure, the production of research, and

¹⁴⁴ Levmore, above n 14; Howell Jackson, 'To What Extent Should Individual Investors Rely on the Mechanism of Market Efficiency: A Preliminary Investigation of Dispersion in Investor Returns' (2003) 28 *Journal of Corporation Law* 671.

¹⁴⁵ Razeen Sappideen, 'Securities Market Efficiency Reconsidered' (1988) 9 *University of Tasmania Law Review* 132, 146.

¹⁴⁶ William Wang, 'Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom under SEC Rule 10b-5?' (1981) 54 *Southern California Law Review* 1217, 1235; William Wang, 'Stock Market Insider Trading: Victims, Violators and Remedies – Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect' (2001) 33 *Securities Law Review* 381, 417; William Wang and Marc Steinberg, *Insider Trading* (2nd ed, 2006) vol 1.

market efficiency, are haphazard, and may lack any foundation.¹⁴⁷ In practice, the impacts of specific research strategies on market efficiency are not known or understood.¹⁴⁸

The primary motivation for investors to engage in securities research is to benefit from an information advantage. While research and trading price signals may enhance the efficiency of the market, not all selective disclosure is value maximising, and there are difficult tradeoffs involved.¹⁴⁹ Merritt Fox suggests that '[p]olicymakers need to assess which [elements impacting market efficiency] ... actually prevail ... and, on the basis of this assessment, determine whether a ban on selective disclosure is desirable'.¹⁵⁰ However, as Langevoort suggests, meaningful empirical research on selective disclosure and private contacts using a cost-benefit calculus is difficult, if not impossible.¹⁵¹

In any event, many of the arguments in relation to selective disclosure, analyst incentives and company access fail to differentiate between institutional investors who provide research and those who do not. Access to listed Australian company information beyond that disclosed on a mandatory basis is not currently based on any research production factor. Closed general analyst and private one-on-one briefings with company management are not restricted to analysts or intermediaries who provide research to the market.¹⁵² Those provided with such access may not provide the market with any research and may not hold or trade in the company's stock. Conversely, those excluded from such access may provide research to the market and may trade significantly in the relevant stock.

No compelling evidence has been found suggesting the security prices of companies that are not covered by analysts are inefficient, primarily because of the lack of analyst coverage, or that companies that are covered by analysts trade efficiently primarily because of the analyst coverage. The potential commissions or investment banking business from some listed companies, particularly smaller companies, may be insufficient for institutions to justify the initiation or maintenance of sell-side analyst coverage. However, companies may compensate for analyst research production by enhanced voluntary disclosures to the broader market. Company management who believe their securities are not trading at appropriate levels now have many cheap and easy options to convey their 'story' directly to existing and potential investors.¹⁵³ Many institutional and retail investors are willing to invest in companies with genuine investment potential regardless of a company's size. This includes many specialist professional funds

¹⁴⁷ Lee, above n 33, 175; Kenneth Boudreaux, 'Competitive Rates, Market Efficiency, and the Economics of Security Analysis' (1975) 31(2) *Financial Analysts Journal* 18, 22.

¹⁴⁸ Jeffrey Gordon and Lewis Kornhauser, 'Efficient Markets, Costly Information and Securities Research' (1985) 60 *New York University Law Review* 761, 792.

¹⁴⁹ Choi, above n 10, 535, 578–9.

¹⁵⁰ Fox, above n 10, 657.

¹⁵¹ Langevoort, above n 20, 1054.

¹⁵² See North, 'Closed and Private Company Briefings', above n 3.

¹⁵³ The challenges for company management are to: identify a shareholder value strategy, clearly explain this strategy to the market, and execute according to plan. To provide sustainable shareholder returns, the business must be able to generate profits or returns in excess of cost of capital over the medium to longer term.

that invest solely in smaller stocks and retail investors who are well informed on particular stocks. In modern developed markets, the search for ‘misvalued stocks’ and an informational advantage is fiercely competitive.

C Excluded Investors Can Obtain Selectively Disclosed Information in the Form of Research

The submissions from retail investors in relation to the Reg FD proposal, and the outlined studies on broker research and conflicts of interest in both the US and Australia, suggest it is difficult for retail investors to benefit economically from sell-side analyst research. Indeed, as fund managers indicated to Boris Groysberg, Paul Healy and David Maber, the main purpose of sell-side research is not to provide optimal investment recommendations and valuations. Instead, the primary value of sell-side analysts and analysis to institutional investors, such as fund managers, is to provide ideas and insights, assist with thinking through of issues, and facilitate superior access to company management.¹⁵⁴ Fund managers generally do their own security valuations and make independent investment decisions. However, few retail investors have sufficient client power to maintain such relationships with sell-side analysts.

D Impact of Regulation Fair Disclosure

The arguments made by critics of Reg FD are that: retail investors would be overwhelmed by the information provided; trading activities and volatility would be significantly altered; companies would have practical difficulties in determining what information to release; companies would no longer be able to present a nuanced presentation of information; companies would reduce the amount and quality of information provided; and the traditional role and function of analysts would be threatened. These arguments seem to have been largely unfounded. Some of the Reg FD studies suggest that companies adjusted their disclosure processes following the enactment of Reg FD by increasing the amount of information publicly disclosed, including increased voluntary earnings disclosures, rather than relying on selective disclosure channels.¹⁵⁵ It appears that some institutional investors and analysts responded to the increased public disclosures by trading after the earnings releases rather than prior to them.¹⁵⁶ On this basis, Reg FD resulted in more equitable access to information, with possible net economic efficiency gains.¹⁵⁷

¹⁵⁴ Boris Groysberg, Paul Healy and David Maber, ‘What Drives Sell-Side Analyst Compensation at High-Status Banks?’ (Working Paper, Harvard Business School, 2008) 33. See also, Kohler, above n 129.

¹⁵⁵ Frank Heflin, K R Subramanyam and Yuan Zhang, ‘Regulation FD and the Financial Information Environment: Early Evidence’ (2003) 78 *Accounting Review* 1, 34; Warren Bailey et al, ‘Regulation Fair Disclosure and Earnings Information: Market, Analyst, and Corporate Responses’ (2003) 58 *Journal of Finance* 2487, 2487, 2512.

¹⁵⁶ Bailey et al, above n 156, 2512.

¹⁵⁷ Heflin, Subramanyam and Zhang, above n 156; Brown, Hillegeist and Lo, above n 115; Bailey et al, above n 156, 2512.

E Conclusion

The arguments that expressly or impliedly suggest that retail investors are protected from selective disclosure because of market efficiency, or that these investors can free ride on the back of institutional investors, are not credible. Furthermore, the argument that selective disclosure to favoured investors is necessary to provide an incentive to analysts to produce research, which in turn is necessary to enhance economic efficiency, is also tenuous. The relationships or links between access to company information, selective disclosure, the production of research, and market efficiency, are haphazard, and may lack any foundation.

The most important information needed for investors to make rational share investment decisions allows investors to assess the sustainability of current earnings and likely future earnings or cash flow. The key source of this information is company management because they are typically in the best position to inform investors about the company's earnings and future growth prospects. Most analysts' reports are founded on or incorporate the information provided by company management, including the information provided publicly and at closed company briefings.

Equal access demands are generally only made in relation to information sourced from companies that will be, or has already been, disclosed to some investors. Company information should be directly accessible by investors, and not filtered through others who have a vested interest in preserving the status quo or protecting their own decisions by defending past judgments.¹⁵⁸ Listed companies are now able to cheaply and easily disseminate information to all investors using modern technologies. Empirical research in the US suggests that an open briefing access policy results in an improvement in the amount and quality of company information provided to the broader market. None of these studies found evidence consistent with a 'chilling' in the amount of information provided by companies during conference calls post Reg FD.¹⁵⁹ Indeed, those that examined the impact of open access suggested or implied an improvement in the information provided to the wider market because of the richness of the information provided during the conference calls.¹⁶⁰ However, while regulators and industry bodies in Australia encourage the use of webcasting and conference calls, such practices remain voluntary, even during result reporting periods.¹⁶¹

Equal access does not prevent anyone from ferreting out, processing, disseminating or trading on publicly available or legally obtainable information. Informational advantages among traders can still be gained through insightful

¹⁵⁸ Arthur Zeikel, 'On the Threat of Change' (1975) 31(6) *Financial Analysts Journal* 17, 19.

¹⁵⁹ Bushee, Matsumoto and Miller, above n 112, 625; Lee, Rosenthal and Gleason, above n 112, 87.

¹⁶⁰ Brown, Hillegeist and Lo, above n 115; Matsumoto, Pronk and Roelofsen, above n 113; Frankel, Johnson and Skinner, above n 113, 149; Bowen, Davis and Matsumoto, above n 114; Brian Bushee, Dawn Matsumoto and Gregory Miller, 'Open versus Closed Conference Calls: The Determinants and Effects of Broadening Access to Disclosure' (2003) 34 *Journal of Accounting and Economics* 149, 178.

¹⁶¹ Some of the submissions to CAMAC suggest the majority of listed companies provide briefing webcasts. However, this was not the case during 2008. Even when webcasts were held, investors were often not provided with 'reasonable' notice of the briefing details.

analysis of public information without having access to inside or outside information. Moreover, information does not need to be private for analysts to make money. Analyst services will continue to be required and compensated when this involves the formulation of ‘independent and accurate expectations in response to the information’.¹⁶²

In any event, many of the arguments in relation to selective disclosure, analyst incentives and company access fail to differentiate between institutional investors who provide research and those who do not. Access to listed Australian company information beyond that disclosed on a mandatory basis is not currently based on any research production factor. Closed general analyst and private briefings are not restricted to analysts or intermediaries who provide research to the market. Those provided with such access may not provide the market with any research and may not hold or trade in the company’s stock. Conversely, those excluded from such access may provide research to the market and may trade significantly in the relevant stock.

When insider trading is banned, market professionals disproportionately capture the insider trading gains, and it is therefore in the interests of these professionals to make it appear that banning insider trading is in the wider public interest.¹⁶³ Moreover, it is generally the recipients, and not the market as a whole, who capture most of the trading gains from selective disclosure, making many of the alleged efficiency gains from selective disclosure doubtful. In a market without any disclosure regulation, institutional investors are likely to systematically lose to better-informed company insiders, but systematically gain at the expense of less informed retail investors as a result of selective private disclosures.¹⁶⁴ This suggests that the enactment of insider trading regulation without supporting regulation prohibiting selective disclosure merely shifts the potential gains from trading on private information from the insiders to the recipients of selective disclosure. Investor confidence in the integrity of a market is just as threatened by outsider trading as insider trading, and the potential negative efficiency impacts from the withdrawal of non-favoured or excluded investors from the market are the same. Consequently, any economic efficiency gains arising from insider trading regulation are likely to be diluted when not supported by regulation prohibiting selective disclosure.

Corporate disclosure and accountability in the public arena is also a critical check to keep retail and institutional incentives and excesses in balance, and to drive robust and sustainable market competition and efficiencies. Retail and institutional incentives are an important element of the relationships between companies and favoured investors, and between intermediaries and retail investors. Stock markets are based on participants competing for profits on a self-interested basis. Human nature is such that there will always be participants who will push boundaries to gain a valuable informational advantage.

¹⁶² Lee, above n 33, 185.

¹⁶³ Jonathan Macey, ‘Ethics, Economics and Insider Trading: Ayn Rand Meets the Theory of the Firm’ (1988) 11 *Harvard Journal of Law and Public Policy* 785, 803.

¹⁶⁴ Langevoort, above n 20, 1046.

Recent global events have starkly highlighted how important institutional accountability and transparency are to the efficient workings of markets and economies. Transparent corporate disclosure in the public arena is therefore likely to be the optimal approach to incentivise genuine research and independent analysis, encourage healthy competition, minimise conflicts of interest, and enhance economic efficiency. A disclosure framework that emphasises and enforces equal access to information promotes genuine competition among *all* investors who are able to process, analyse and trade on company information. Competition among investors should be based on superior analytical skills rather than on who can: get the best access to company management; win sufficient favour with the management to obtain the best information; and write sufficiently favourable reports to maintain regular access.¹⁶⁵

Arguments and proposed institutional structures based on simplistic views or assumptions about the roles of particular groups of market participants are likely to be grounded on profit incentives rather than efficiency or fairness concerns. Policy makers need to be aware that regulation governing access to information has enormous financial consequences. Company management and large investors sometimes have ‘strong incentives to oppose additional disclosures on a timely basis, even when such disclosure is essentially costless’.¹⁶⁶ In financial markets, informational advantages are synonymous with making money or success. This is true whether the information used to make profits is obtained legally or illegally, because of a privileged position or luck, or through skill and diligence. All other things being equal, those with superior access to information prosper to the detriment of those with poorer access.

¹⁶⁵ Lopez-Fernandini, above n 154.

¹⁶⁶ Nils Hakansson, ‘On the Politics of Accounting Disclosure and Measurement: An Analysis of Economic Incentives’ (1981) 19 (Supplement) *Journal of Accounting Research* 1, 27.