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Recent changes in disclosure regulation: Description and evidence

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Abstract

Technology has dramatically reduced the cost of disclosing information to investors and created new conduits for securities' sales. The result is stock ownership, both direct and indirect, has never been more widely distributed. Equally important, changes have occurred in the institutional market for new offerings. Bought deals, Internet road shows, the preeminence of mutual funds and pension funds, and foreign investors and issuers have changed the market. In the wake of these changes, the SEC's disclosure policy has evolved. The evidence suggests we have moved from a world where information was released relatively infrequently and with significant lags to a world where information is released relatively rapidly on a continuous basis to as many investors as possible.

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1. Introduction

Between September 1929 and July 1932, stocks listed on the NYSE lost 83% of their market value.[1] In response to devastating investor losses that arose from weak economic conditions and securities fraud, Congress passed the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), which among other initiatives, established the Securities and Exchange Commission (SEC). The purpose of these Acts was to promote full public disclosure of company information and to protect the investing public against fraudulent and manipulative practices in the securities markets.

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[1] See www.sechistorical.org/museum/timeline/index.php.

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Since that time, a number of important social, technological and demographic changes have strained the original regulatory framework. As a backdrop, in the 1930s there was no "equity culture" in the United States, in that most companies' equity holdings were concentrated in the hands of a few wealthy and sophisticated investors. The average person did not own common stock. Communication between issuers and investors was relatively simple and slow, at least by modern standards, and very expensive.

Since then, technology has dramatically reduced the cost of disclosure to and communication with investors, resulting in an increasing ease with which both professionals and non-professionals can access fundamental market information. Primary sources of information include the SEC's EDGAR system, which distributes about ten gigabytes of data (three million pages) per day through the Commission's Web site.[2] Secondary sources, including print, electronic, and televised forms, further lower investor's costs of learning about companies and offerings.[3] One result is stock ownership, both direct and indirect, has never been more widely distributed. Equally important, changes have occurred in the institutional market for new offerings. Bought deals, Internet road shows, the preeminence of mutual funds and pension funds, foreign and other institutional investors are all factors not envisioned by Congress in the 1930s. The rise of wealthy and financially sophisticated institutional investors has changed the costs and benefits of mandated disclosure to some investors.

Congress and the SEC have tried to keep pace with these changes by passing laws and adopting new rules. The courts have updated securities regulation by interpreting decades-old rules in more current contexts. In the 1990s, however, the age of the securities laws began to show. New modes of communication did not fit easily into existing rules. The run-up in the market attracted investors who previously had not participated in it. Revelations of corporate abuse showed evidence of regulatory inadequacies. In response, Congress and the SEC adopted new rules and revised others to address the changed environment.

In this Special Issue, some of the papers examine certain aspects of the current regulatory regime. But before discussing any specific studies, I first offer context for these studies by presenting an overview of several trends in disclosure regulation – trends that are evident in recent rule changes adopted by the SEC and promulgated in laws by Congress – that began in the late 1990s and continue today. I then briefly discuss how four of the papers in this Special Issue contribute to our understanding of the regulatory landscape. I conclude by identifying a number of areas that we do not yet fully understand and discuss how future work might address these gaps in our knowledge.

2. Recent trends in disclosure regulation

2.1. More comprehensive disclosure

The first trend in disclosure regulation is requiring firms to provide more comprehensive disclosure. The Exchange Act requires firms to disclose information to the public about their financial and managerial conditions that is considered to be 'material', while the Securities Act requires firms to disclose 'material' facts about securities being offered and sold. Before 1999, the

[2] Estimate from the SEC's 1999 Congressional Budget. Before EDGAR came on-line in 1984, Disclosure Inc. reproduced and sold SEC filings for about $0.15 per page.

[3] These sources include *Barron*'s, *Wall Street Journal, Money* (print), *First Call, The Motley Fool, Bloomberg* (electronic), and *Wall Street Week* and CNNfn (television). Specialized publications have arisen as well, such as *Red Herring*, a monthly magazine that caters to the world of high-tech initial public offerings.

SEC provided little guidance as to the types of information that might be considered 'material'. As such, materiality was largely defined through legal opinions issued in cases such as Basic v. Levinson[4] and TSC Industries v. Northway.[5] These decisions stipulated that managers needed to disclose information if "there was a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision or that it would have been viewed by a reasonable investor as having "significantly altered the 'total mix' of information available." Managers generally interpreted case law as requiring them to disclose changes in assets, sales or net income over some numerical threshold, such as five or ten percent.

In 1999 the SEC reversed its previous policy of near silence on the topic by issuing Staff Accounting Bulletin (SAB) 99, which provided additional guidance to managers for determining whether changes in financial statements might be considered material.[6] Importantly, the SEC focused not only on accounting-based tests, but also on market-based tests; for example, whether disclosure would likely cause a significant change in share price or the volatility of a firm's stock price. In SAB 99 the SEC also focused on managerial intent for mis-statements, such as actions to manage earnings. The SEC specified that concealments of unlawful transactions or concealment that would cause an increase in management's compensation would likely be viewed as being material. In SAB 99, the SEC explicitly rejected numerical thresholds as bright line tests.

In 2000 the SEC adopted Regulation Fair Disclosure (Regulation FD),[7] which provided further guidance as to what changes in firm operations or financial condition might be considered material. In Regulation FD, as some of the papers in this Special Issue discuss, managers are precluded from selectively disclosing information to securities professionals and investors before that information has been disseminated to the general public. In Regulation FD, the SEC spells out specific types of information that it considers to be material enough that it would be precluded from being selectively disclosed; for example, earnings information, mergers, acquisitions, tender offers, joint ventures, or changes in assets, new products or discoveries, changes in control or management, changes in an auditor, or defaults on senior securities, bankruptcies or receiverships. Importantly Regulation FD does not impose an affirmative burden on managers to reveal this information, but rather requires firms to broadly disseminate such information if they disseminate it at all.

In 2004 the SEC went yet a step further when it revised Form 8-K disclosures.[8] Form 8-K historically has been used by firms to disseminate information to the market about important changes in operations or financial condition. In 2004 the SEC issued additional guidance as to the kinds of items that should be disclosed on Form 8-K. Such information included: unregistered sales of equity securities by the company, material modifications to rights of securities holders, changes in a certifying accountant, departure of directors or principal officers. The list provided by the SEC is tremendously rich, and in contrast to Regulation FD, creates an affirmative burden for firms to disclose this information. Taken together, these regulatory initiatives resulted in the SEC adopting a dramatically different stance relative to the pre-1999 period when it provided little guidance as to the types of information that might be deemed material and therefore would likely need to be disclosed to the investing public.

[4] Basic v. Levinson, 485 U.S. 224, 231 (1988).

[5] TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438, 449 (1976).

[6] Staff Accounting Bulletin No. 99, August 12, 1999.

[7] Selective Disclosure and Insider Trading, Release No. 33-7881, August 15, 2000.

[8] Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release No. 33-8400, March 16, 2004.

2.2. Frequency of disclosure

The second trend that has emerged over the last 7 or 8 years is a shift from periodic and transactional disclosure to on-going or continuous disclosure. Before 2004, reporting companies under the Exchange Act filed three quarterly reports and one annual report each year, and occasional Form 8-Ks when circumstances warranted it. When the SEC adopted the 2004 changes to Form 8-K, discussed above, it shifted certain items from annual and quarterly reports to Form 8-K.[9] Specifically, firms now need to file information concerning unregistered sales of equity securities and material modifications to rights of security holders on Form 8-K rather than on periodic reports.

As part of the shift from periodic to continuous disclosure, the SEC also began requiring quicker Exchange Act reporting by firms. For example, Regulation FD requires managers to release information simultaneously to all investors if it is known to be material or promptly; that is, within 24 hours, if managers inadvertently disclose material information.[10] In its changes to Form 8-K, the SEC shortened the period within which firms must disclose certain material events from five business or 15 calendar days to four business days,[11] and in 2002, the SEC accelerated the filing period for Forms 10-K and 10-Q.[12] Large firms used to have 90 days to file their 10-Ks; now they have 60 days. Large firms had 45 days to file their Form 10-Qs, now it is 35 days. For medium size firms, they had 90 days to file their 10-Ks and 45 days to file their 10- Qs. Now they have 75 days for 10-Ks and 40 days for 10-Qs.

We see a similar shift towards continuous reporting of transactions under the Securities Act. When firms offer securities to the public, the Securities Act requires them to register the securities with the SEC. The Securities Act stipulates that firms disclose information about themselves, information about the securities being offered for sale, and the expected use of proceeds. The SEC's staff historically has had the option of reviewing preliminary prospectuses for accuracy and completeness, and in some instances it has requested changes. Staff reviews can take weeks or even months to complete and may require several iterations with firms. In 2005 the SEC adopted new securities regulations that have expanded what is known as 'shelf registration' into something that looks like 'company registration'.[13] In the new regime, companies for which the SEC believes the market for their shares is efficient are able to raise capital without regulatory delays. Companies, rather than offerings, are registered and the investing public relies on on-going rather than transactional disclosure.

2.3. Fair disclosure

The third trend that has become apparent is a push towards broader dissemination and accessibility to information by investors. In recent years, the SEC has articulated a desire for investors with few private resources to be able to access and analyze company information on a more equal footing with sophisticated and professional investors. To reach this goal of "fair" disclosure, the SEC adopted in 2000 Regulation FD, which requires managers to disseminate

[9] Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release No. 33-8400, March 16, 2004.
[10] Selective Disclosure and Insider Trading, Release No. 33-7881, August 15, 2000.
[11] Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release No. 33-8400, March 16, 2004.
[12] Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Release No. 33-8128, September 5, 2002.
[13] Securities Offering Reform, Release No. 33-8591, July 19, 2005.

information broadly if they disseminate it to any investors or securities markets professionals.[14] Regulation FD attempts to eliminate trading profit opportunities that are based on differential access to information. Similarly, managers and other 'insiders' are prohibited from trading based on disparate knowledge. In addition, the SEC adopted its Plain English rules in 1998 to minimize the legalese in on-going and periodic reports, as well as registration statements.[15] The goal was to make corporate disclosure comprehensible to investors who do not have legal training. In 2002, the SEC adopted rule amendments that require foreign companies and foreign governments to file their Securities Act and Exchange Act documents electronically through EDGAR, making them broadly accessible.[16] The SEC previously had required that these documents be accessible only at the SEC's headquarters in Washington D.C. In 2005 the SEC adopted rules that required firms that used electronic road shows for IPO's to make them available to unrestricted audiences.[17]

2.4. Accountability for full and fair disclosure

The fourth and final trend is greater CEO and CFO personal accountability for the quality of accounting statements. Section 906 of the Sarbanes–Oxley Act of 2002 requires CEOs and CFOs of public companies to certify the accuracy of all periodic reports.[18] Section 302 of the same Act requires CEOs and CFOs to certify the adequacy of internal controls as well as the accuracy of periodic reports.[19] In recent years, the SEC has held several CEOs and CFOs, as well as their companies, accountable for violations of Regulation FD. For example, in November 2002, the SEC issued cease and desist orders against Raytheon Company and its CFO and against Secure Computing Corporation and its CEO. The SEC sent a clear message that senior managers of firms are responsible for the content and process by which information is disseminated to investors.

3. Measuring the costs and benefits of disclosure regulation

The purported purpose of these regulatory changes has been to promote full, fair, and timely public disclosures of firm information to the securities markets. The question then is how have these recent trends affected investors and companies? What are the costs and benefits? One concern in the wake of regulatory changes such as Regulation FD, for example, is that communication from issuers to investors may be chilled, because managers fear the liability that may be associated with the process of disseminating information. Prior research and the papers in this Special Issue help provide insight to this question. Prior research looks at the quantity and quality of information in the market; specifically there are papers that look at the frequency at which managers release information; at analyst's coverage of firms through time; at analyst forecast accuracy; and at the errors and dispersion of analyst forecasts. Papers also look at trading volume to see if more information is being disseminated now than before. Previous studies examine stock price volatility and stock price reactions to see if investors are revising their estimates of stock valuations faster now than before Regulation FD.

In this Special Issue, several papers further this conversation about the costs and benefits of Regulation FD. Madureira, Gomes, and Gorton (2007-this issue) examines whether the adoption

[14] Selective Disclosure and Insider Trading, Release No. 33-7881, August 15, 2000.
[15] See Plain English Disclosure, Release No. 33-7497, January 28, 1998.
[16] Mandated EDGAR Filing for Foreign Issuers, Release No. 33-8099, May 14, 2002.
[17] Securities Offering Reform, Release No. 33-8591, July 19, 2005.
[18] Pub. L. 107-204, 116 Stat. 745 (2002).
[19] Certification of Disclosure in Companies' Quarterly and Annual Reports, Release No. 33-8124, August 29, 2002.

of Regulation FD has changed firms' costs of capital. The findings indicate Regulation FD has caused small firms' costs of capital to increase which is consistent with selective disclosure being a low cost means for these firms to disseminate information to the market. Ahmed and Schneible (2007-this issue) examine trading volume around earnings announcements before and after the implementation of Regulation FD. The results indicate that although the quantity and quality of information in the market is largely unchanged for most firms, it is worse for small and high-tech firms. Finally, Collver (2007-this issue) finds some evidence of deterioration in the quality of information in the market after the implementation of Regulation FD, although this change is swamped by the impact of decimalization on the NYSE.

Rodrigues and Stegemoller (2007-this issue) identifies an area in the securities law where the definition of what needs to be disclosed might not yet be broad enough. The SEC requires publicly held firms to disclose financial information about privately-held targets if targets are likely to be 'significant' subsidiaries, and the SEC provides guidance as to what constitutes 'significant'. Rodrigues and Stegemoller find that approximately 80% of acquisitions of privately held firms that are 'insignificant' according to the SEC's definition are nevertheless economically important to acquirer firms; that is; announcements of these acquisitions affect acquiring firms' share prices. One implication is further modification and guidance in the securities laws on what constitutes 'significant' may be necessary.

4. What do we not know about disclosure regulation?

Given the quantity and quality of prior research and the papers in this Special Issue, what is it that we do not yet know or understand about disclosure regulation? Certainly in the Regulation FD area, there have been a number of research studies, and consensus is starting to be reached as to its costs and benefits. But we know little if anything about the non-Regulation FD disclosure changes discussed here and how they have affected investors and companies. For example, the changes to Form 8-K in 2004 were viewed by many industry participants as being far broader reaching than the changes imposed by Regulation FD. Regulation FD required that if managers disclosed information, then they needed to disclose it broadly, but it did not directly affect the type of information that needed to be disclosed. In contrast, the changes adopted by the SEC to Form 8-K require additional information to be disclosed. Similarly there has been little if any work on the effects of the adoption in 1998 of the Plain English rules by the SEC, the impact of SAB 99 or the Securities Offering Reform of 2005. We have virtually no information about how these recent non-Regulation FD disclosure changes are affecting the quantity or quality of information in the market or how they are affecting investors and companies.

The second question for which we do not know the answer is how information is best disseminated. The SEC's recent changes in disclosure regulation have led to the fragmentation, both in location and time, of information. In the past, managers filed 10-Ks, 10-Qs, and 8-Ks through the SEC's web site, EDGAR. Now, however, under Regulation FD managers can provide 'broad, non-exclusionary' disclosure of information either on Form 8-K through EDGAR or through press releases, conference calls or web sites. The result is that information is released in multiple venues. The question is, how well do investors assimilate information if it is released in one of several possible locations as opposed to being filed in a single location? Little if any work has been done to assess the ability of investors to aggregate information located in different places.

The SEC's changes in disclosure regulation have also led to intertemporal fragmentation of information. When most of the information that was required to be filed was released on 10- Ks and 10-Qs, information was released, definitionally, four times each year. Now with the expansion of Form 8-K and adoption of Regulation FD, managers continuously release information, contributing to intertemporal information fragmentation. Again, little if any work has been done to assess the ability of investors to aggregate information through time. We also don't know how firms' management of information releases affects business decisions or how more frequent releases of information affect competitors.

The third question for which we have little understanding is; does enhanced disclosure affect the quality and quantity of all firms' information in the market equally? The results of several of the papers in this Special Issue give rise to this question. For example, the results of Madureira, Gomes, and Gorton (2007-this issue), Ahmed and Schneible (2007-this issue), and Collver (2007-this issue) suggest that Regulation FD may have affected the quality and quantity of information for firms differently based on characteristics such as size and product line. We have little if any information concerning important differences across other attributes. We also have little information on cross-sectional differences between firms for non-Regulation FD rule changes.

The fourth and final question is how important is disclosure for investors in less-regulated entities and unregulated offerings? Certain of the new regulations do not apply to all companies; for example, the SEC now grants regulatory relief from some of the reporting requirements for transactions of large well-followed firms. On the other end of the spectrum, the SEC requires only limited disclosure by small firms, and foreign private issuers are exempt from some regulatory requirements. Private placements are virtually unregulated. The question that remains is, if full, fair, and timely disclosure is important for investors in mid-sized domestic firms, is it also important for investors in these other firms and in private transactions?

These questions are important given the future demographics of the United States. The baby-boomers of the 1950s and 1960s are now reaching retirement age. The U.S. Census Bureau estimates that the number of people who are 65 or older will go from 36.6 million in 2005 to over 63 million in 2025.[20] These people are likely to be disinvesting from homes, exiting out of corporate retirement plans, and putting their funds to work elsewhere in the market. The past two decades has witnessed a dramatic disintermediation of the financial markets, with retail investors increasingly holding financial assets directly or through mutual funds. These SEC needs to consider these demographic changes and know the answers to these questions as it contemplates the adoption of future rules or dismantling of existing rules.

5. Conclusion

Congress in the 1930s could not have anticipated the forms of communication that are available today or the sophistication and participation of retail investors in the markets. These changes, coupled with advances in technology and the globalization of the securities markets, have accelerated in recent years, creating tremendous regulatory strains on the securities laws.

Over the last decade, the SEC has responded by adopting rules to help modernize its regulatory oversight of the securities markets. We have moved from a world where information was released relatively infrequently and with significant lags to a world where information is released relatively rapidly on a continuous basis to as many investors as possible. The papers in this Special Issue demonstrate the SEC's regulatory choices have costs and benefits. The SEC's mission includes both protecting investors and promoting capital formation, goals that are not always congruent. Several of the papers in this issue suggest the adoption of Regulation FD, for example, may have

[20] See www.census.gov/population/projections/SummaryTabC1.xls.

enhanced the fairness of disclosure, but compromised the quality and quantity of information in the market, resulting in a higher cost of capital for firms and shareholders. In contrast, the SEC, by allowing firms to not disclose many mergers, may have lowered investor protection in the name of conserving issuer cost. These findings highlight the conflicts that can arise between the SEC's goals, and the importance of understanding the costs and benefits of regulatory initiatives. My hope is that this Special Issue will help to continue and advance these conversations.

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