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SEC Regulation Fair Disclosure, information, and the cost of capital ☆

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Abstract

Regulation Fair Disclosure ("Reg FD"), adopted by the U.S. Securities and Exchange Commission in October 2000 was intended to stop the practice of "selective disclosure", in which companies give material information only to a few analysts and institutional investors prior to disclosing it publicly. Our analysis shows that the adoption of Reg FD caused a significant shift in analyst attention, resulting in a welfare loss for small firms, which now face a higher cost of capital. The loss of the "selective disclosure" channel for information flows could not be compensated for via other information transmission channels. This effect was more pronounced for firms communicating complex information and, consistent with the investor recognition hypothesis, for those losing analyst coverage. Moreover, we find no significant relationship of the different responses with litigation risks and agency costs. Our cross-sectional results suggest that Reg FD had unintended consequences and that "information" in financial markets may be more complicated than current finance theory admits.

JEL classification: G12; G14; G18; G24; G28; K22
Keywords: Disclosure; Regulation; Capital markets; Cost of capital; Regulation fair disclosure; Reg FD; Information production

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1. Introduction

We empirically investigate the effects of the adoption of Regulation Fair Disclosure ("Reg FD") by the U.S. Securities and Exchange Commission ("SEC"). Reg FD, which took effect on October 23, 2000, was intended to stop the practice of "selective disclosure," in which companies give material information only to certain selected analysts and institutional investors prior to disclosing it publicly. To provide an evaluation of Reg FD it is important to understand both how information is transmitted from firms to capital markets and how the allocation of information-producing resources affects securities prices. We find that the adoption of Reg FD caused a significant reallocation of information-producing resources, resulting in a welfare loss for small firms, which now face a higher cost of capital. The loss of the "selective disclosure" channel for information flows could not be compensated for via other information transmission channels. This unintended consequence of Reg FD shows that "information" in financial markets is more complicated than current theory admits and has some important public policy implications.

There were three reasons given by the SEC for the adoption of Reg FD. First, it was argued that selective disclosure leads to a loss of investor confidence. If small investors fear that insiders will regularly profit at their expense, they will not be nearly as willing to invest. A second rationale concerned the link between corporate governance and the incentives to engage in selective disclosure. This problem was the use of information by management to essentially bribe analysts, perhaps in exchange for a quid pro quo. Finally, the SEC stated the view that selective disclosure is not required for market efficiency because of technological change. The basic idea seems to be that companies can now use websites and/or "webcast" conference calls, making the channel of information flow from firm management to analysts less important.

Is Reg FD a desirable public policy? We focus on assessing the effects of Reg FD on information production and transmission in capital markets; we ask whether the same information is transmitted to capital markets since the passage of Reg FD, just via a different channel now (albeit in a possibly "fairer" way), or whether, for some reason, there is less information transmitted to capital markets. We view this issue as of independent interest. Little is known about whether the sources of information or the costs of producing the information have any impact on firm values and security prices. Ultimately, we care about the effects on security prices and the resulting allocation of resources. We use the natural experiment of the adoption of Reg FD to investigate these issues.

Information can be transmitted from firms to markets via four channels: (1) firms, in addition to mandatory disclosures, can disclose information to the public voluntarily (e.g., earnings pre-announcements); (2) firms can selectively disclose information, e.g., phone calls, or one-on-one meetings; (3) "sell-side" analysts can produce research which is released to the public, e.g., analysts reports; (4) private information can be produced by outsiders, "informed traders," who then trade on the basis of their information. Reg FD sought to eliminate the second channel of information flow, under the implicit assumption that the same information would still flow into markets but by the other channels, particularly channel (1). But, Reg FD also affects channel (3) because the biggest impact of Reg FD is on analysts. Some have predicted that Reg FD will either lead to a diminished role for analysts since the information will now be available for everyone or a large-scale reduction in analysts' jobs since many simply cannot perform an adequate analysis without the aid of selective disclosure (Coffee, 2000). If analysts' previous role is subsumed by the other channels of information flow, then market efficiency is not changed. This is the logic of Reg FD that is our focus.