

Selective Disclosures in the Public Capital Markets

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Publicly-traded corporations contain a wealth of non-public material information. Insider trading prohibitions limit the ability of corporate insiders to profit from this information advantage through trades in their own corporations' securities. Some may view the SEC's recently promulgated Regulation FD, which limits the ability of firms to confer on outsiders a similar inside information advantage through selective disclosures, as complementary to restrictions on insider trading. The employment of selective disclosures to favor outside investors and analysts, nonetheless, may provide a number of benefits to all shareholders of a corporation. Selective disclosures, for example, may help subsidize analysts that otherwise may not cover the disclosing firm. Selective disclosures also may provide firms a low-cost and flexible means of conveying even confidential information indirectly into the capital markets. This Article contends that the real risk of selective disclosures lies with the potential for managers to co-opt such disclosures for their own opportunistic endeavors. Regulation FD, however, represents an untailored and overly broad response to the risk of opportunism. Instead, this Article sets forth a number of more tailored regulatory responses that allow firms to provide selective disclosures in situations where overall investor welfare is enhanced while curtailing more opportunistic uses.

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INTRODUCTION

Informational disparities abound in the capital markets. Not all market participants have access to the same information or expertise to assess the information on any particular company. Some investors, including large institutional investors, have both many years of market experience as well as large research departments devoted to analyzing stock market prices.¹ Other investors, such as individuals with small net value portfolios, have neither the time nor the resources to engage in detailed financial research.² Parties with an information advantage in the securities markets obtain benefits from such advantage through trades with other more uninformed parties. A flow of transactions, in turn, allows securities prices in the U.S. capital markets to incorporate the constant arrival of new information.

Whether the presence of informational disparities in the securities markets results in a net benefit or loss to investors as a group depends on the circumstances surrounding the disparities. Market participants with

¹ For example, Fidelity Investments, a large mutual fund company based in Boston, has almost \$900 billion in managed assets. See *Fidelity Investments Introducing Two New Stock Funds*, BUSINESS WIRE, Dec. 21, 2000.

² Until the early 1990s, individual investors comprised the majority of investors in the U.S. securities markets. See Michael Siconolfi, *Individual Investors' Holdings of U.S. Stocks Fall Below 50% of Total Market for the First Time*, WALL ST. J., Nov. 13, 1992, at C1.

an information advantage benefit systematically at the expense of participants without such an advantage. Indeed, the ability to benefit from an information advantage is the primary motivation for many investors to engage in securities research. On the one hand, investors may engage in duplicative research efforts, resulting in socially inefficient information expenditures.³ Uninformed investors trading against those with an information advantage may also lose confidence in the capital markets, resulting in an overall drop in market liquidity.⁴ On the other hand, parties with non-public information provide signals through trades to the rest of the market on the value of particular securities. Market makers and other market participants may then react to the signals with a shift in transaction prices,⁵ thereby raising the accuracy with which prices — at least in an efficient market⁶ — reflect the

³ See, e.g., Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971). Hirshleifer argues that where information is used simply to redistribute assets in an exchange economy, the information research generates no new value to the market as a whole. See *id.* at 562–66. See also John C. Coffee, Jr., *Market Failure and the Economic Case For a Mandatory Disclosure System*, 70 VA. L. REV. 717, 733–34 (1984) (stating that “[f]rom a social welfare perspective, trading gains do not create additional wealth; one party’s gain comes at the other party’s loss, whereas the process of researching and verifying securities information consumes real resources.”). As more market participants engage in research, the returns from research will drop (with the increase in securities price accuracy). At some point, the returns from research will just balance the costs, providing market participants with a competitive rate of return. For a description of the relationship between securities price efficiency and the incentives of market participants to engage in research, see Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980).

⁴ See John Marshall Cook, Comment, *The Securities Enforcement and Penny Stock Reform Act of 1990: The Cost of Flexibility*, 6 ADMIN. L.J. AM. U. 359, 391 n.235 (1992) (noting that “[t]he concept of market confidence revolves around the individual investors. If individual investors are not confident that the market is running smoothly, they will be reluctant to invest.”).

⁵ For example, market makers publish separate bid and ask prices at which they will purchase and sell securities of a company they cover. When the market maker observes a large amount of sale orders, the market maker may respond by lowering both its bid and ask prices, resulting in lower transaction prices as additional orders flow in to the market maker.

⁶ See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 572–77 (1984) (describing how uninformed investors may become informed through “trade decoding” through direct observations of informed investor trades). Of course, where the market price is not reflective at all about the underlying fundamental value of a corporation, signals from trades may not increase the accuracy of stock market prices. See Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 853–54 (1992); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 648–50 (1995) (reporting skepticism on part of financial economists on validity of efficient market hypothesis); William K.S. Wang, *Some Arguments that the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341, 344–49 (1986) (discussing distinction between “fundamental valuation” efficiency and “information arbitrage” efficiency).

underlying value of a corporation. Accurate securities prices reduce mispricing risks facing uninformed investors and help third parties that depend on the accuracy of securities prices in making capital allocation decisions.⁷ More accurate securities prices also mitigate the cost of using equity-based compensation to managers.⁸

Regulators recently have focused on one particular source of informational disparities in the capital markets: when companies disclose non-public material information to only a select group of analysts and investors (termed “selective disclosures”). In particular, the Securities and Exchange Commission (“SEC”) promulgated new regulations restricting selective disclosures under Regulation FD that became effective in October 2000.⁹ Touted as a positive step toward protecting the “integrity” of the capital markets,¹⁰ Regulation FD works to block most — although not all — forms of selective disclosures.¹¹

This Article assesses selective disclosures from the perspective of overall investor welfare, arguing that selective disclosures really encompass two logically disparate situations: where managers work in the best interests of the firm and where, conversely, managers act opportunistically. Part I provides a general overview of the scope of Regulation FD. Part II argues that in the case of managers working in

The remainder of this paper assumes that prevailing market prices represent the market’s best guess given all available public information on the fundamental value of the corporation. Such an assumption is justified to the extent securities trade in an “efficient” market. Several versions of the efficient market hypothesis exist. The semi-strong version of the efficient capital markets hypothesis posits that the secondary market price of companies reflects all publicly available information on the company. See Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) (providing survey of theoretical implications of efficient markets and empirical testing of efficient markets hypothesis); see also Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud in the Market Theory*, 74 CORNELL L. REV. 907, 911 & 912 n.11 (1989) (“The empirical evidence to date (with some exceptions) appears to establish the validity of the weak and semi-strong but not the strong form of the efficient capital markets hypothesis.”).

⁷ Several external parties may look to the securities price of a particular company for information. A potential competitor, for example, in deciding whether to enter the product market of the company may look to the company’s stock price to determine the potential profitability of the market. See *infra* text accompanying notes 99-101 (discussing possibility of third party externalities related to accurate securities market pricing).

⁸ Managers that are compensated through equity hold an undiversified position in their company. Risk-averse managers will then demand a greater expected level of compensation to compensate for the risk they bear from the equity-based compensation.

⁹ See Selective Disclosure and Insider Trading, Exchange Act Release No. 34-43154, 2000 WL 1201556 (Aug. 15, 2000) [hereinafter SEC Promulgating Release]. Regulation FD represents the culmination of one of former SEC chairman Arthur Levitt’s top priorities. See David Schellhase, *Arthur Levitt’s Cultural Crusade*, THE RECORDER, Aug. 16, 2000, at 4.

¹⁰ See SEC Promulgating Release, *supra* note 9, at *2.

¹¹ See *infra* Part I (describing operation of Regulation FD).

the firm's best interests, Regulation FD has little justification. Part III then observes that Regulation FD may in fact protect against managerial opportunism. Nevertheless, Part III contends that Regulation FD ineffectively restrains managerial opportunism while limiting the ability of large block shareholders to monitor managers for agency problems. Part IV then proposes alternative selective disclosure-related reforms that target managerial opportunism more directly.

I. THE SCOPE OF REGULATION FD

Regulation FD focuses its attention on Securities Exchange Act of 1934, ("Exchange Act"), reporting U.S. companies¹² and those working on the behalf of such companies (collectively referred to as "company sources").¹³ Company sources include "any senior official of the issuer" as well as "any other officer, employee, or agent of an issuer who regularly communicates" with certain capital market participants.¹⁴

¹² The Exchange Act imposes periodic information reporting requirements for certain issuers, commonly known as "Exchange Act reporting companies". Companies listed on a national securities exchange must register and comply with the SEC's periodic information disclosure requirements. See Securities Exchange Act of 1934, 15 U.S.C. § 78m(a) (1994); Securities Exchange Act of 1934, 15 U.S.C. § 78l(b) (1994); see also Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(1) (1994) (defining "exchange" for purposes of Exchange Act). As well, companies whose total assets exceed \$10 million and have a class of equity security (other than an exempted security) held of record by more than 500 shareholders must register the securities under the Exchange Act and thereby come under the periodic reporting requirements of Section 13(a). See Securities Exchange Act of 1934, 15 U.S.C. § 78m(a) (1994); Securities Exchange Act of 1934, 15 U.S.C. § 78l(g) (1994); see also 17 C.F.R. § 240.12g-1 (2001) (raising asset requirement to \$10 million). In addition, firms that engage in a registered public offering must comply with the periodic reporting requirements for at least one fiscal year. See Securities Exchange Act of 1934, 15 U.S.C. § 78o(d) (1994).

These required periodic information filings include annual Form 10-K, quarterly Form 10-Q, and occasional Form 8-K documents. See 15 U.S.C. § 78m(a); 17 C.F.R. § 240.13a-1 (2001) (providing rules on periodic disclosure requirements of Exchange Act registered companies); 17 C.F.R. § 249.310 (2001) (Exchange Act Form 10-K); 17 C.F.R. § 249.308 (2001) (Exchange Act Form 8-K); 17 C.F.R. § 249.308a (2001) (Exchange Act Form 10-Q). Companies which recently filed a registration statement which has become effective under the Securities Act must also comply with the periodic reporting requirements. See Securities Exchange Act of 1934, 15 U.S.C. § 78o(d) (1994).

¹³ See 17 C.F.R. § 243.101(b) (2001) (defining "issuer" to encompass primarily Exchange Act reporting companies); 17 C.F.R. § 243.101(c) (stating that "'Person acting on behalf of an issuer' means any senior official of the issuer (or, in the case of a closed-end investment company, a senior official of the issuer's investment adviser), or any other officer, employee, or agent of an issuer who regularly communicates with any person described in § 243.100(b)(1)(i), (ii), or (iii), or with holders of the issuer's securities.").

¹⁴ 17 C.F.R. § 243.101(c). See also SEC Promulgating Release, *supra* note 9, at *9 ("[T]o the extent that another employee had been directed to make a selective disclosure by a member of senior management, that member of senior management would be responsible for having made the selective disclosure.").

Regulation FD applies only to company sources contemplating the disclosure of nonpublic material information to certain delineated groups of capital market participants.¹⁵ The delineated groups of participants include four categories of entities: broker-dealers, investment advisors, investment companies, or any investor that is reasonably expected to trade on the information.¹⁶ If a company or a company source makes selective disclosure of nonpublic material information to any of the aforementioned groups, it must also disclose the information to the market at large.¹⁷

Several exclusions exist for the application of Regulation FD. Communications made to parties that owe the issuer a duty of trust or confidence — including attorneys, investment bankers, and accountants (so-called “temporary insiders”) — are exempt from Regulation FD.¹⁸ In addition, communications made to parties that agree to keep the information confidential are also exempt from the scope of Regulation FD.¹⁹ Disclosures made to credit rating agencies are exempt from Regulation FD, as are communications made during a registered public offering pursuant to the Securities Act of 1933 (“Securities Act”).²⁰ Foreign private issuers (as well as foreign governments) are also exempt from the coverage of Regulation FD.²¹

Regulation FD limits the ability of market participants to profit from selective disclosures through the requirement that issuers, among others, must make “public disclosure” of the information upon the occurrence of a selective disclosure.²² Public disclosure is defined to include the filing

¹⁵ See 17 C.F.R. § 243.100(a) (requiring issuers to make public disclosures of non-public material information disclosed selectively to persons described in 17 C.F.R. § 243.100(b)(1)).

¹⁶ 17 C.F.R. § 243.100(b)(1).

¹⁷ See 17 C.F.R. § 243.100(a)-(b)(1).

¹⁸ See 17 C.F.R. § 243.100(b)(2)(i).

¹⁹ See 17 C.F.R. § 243.100(b)(2)(ii); SEC Promulgating Release, *supra* note 9, at *8 (“This approach recognizes that issuers and their officials may properly share material nonpublic information with outsiders, for legitimate business purposes, when the outsiders are subject to duties of confidentiality.”).

²⁰ See 17 C.F.R. § 243.100(b)(2)(iii). On the other hand, the SEC explicitly included communications made during a private placement within the scope of Regulation FD. See SEC Promulgating Release, *supra* note 9, at *18 (noting that “[u]nregistered offerings are not subject to the full public disclosure and liability protections that the Securities Act applies to registered offerings.”).

²¹ See 17 C.F.R. § 243.101(b) (2001). See also Securities Act, 17 C.F.R. § 230.405 (2001) (defining “foreign private issuer”). See also Merritt B. Fox, *Regulation FD and Foreign Issuers: Globalization’s Strains and Opportunities*, 41 VA. J. INT’L LAW 653 (2001) (examining policy rationale for excluding foreign private issuers from reach of Regulation FD).

²² See 17 C.F.R. § 243.100(a).

of the disclosed information with the SEC on Form 8-K.²³ Issuers may also satisfy the public disclosure requirement if the issuer “instead disseminates the information through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public.”²⁴ Where the selective disclosure is intentional, then the company must simultaneously make the public disclosure.²⁵ If non-intentional, then the company must publicly disclose the information to the market within 24 hours of the selective disclosure or by the time trading commences on the New York Stock Exchange, whichever comes sooner.²⁶

The SEC specifically excluded private causes of action for violations of Regulation FD to reduce the chilling effect from the possibility of frivolous suits.²⁷ The SEC also explicitly provided that failure to file a Form 8-K, when no other qualifying form of public disclosure is made, will not disqualify issuers from using Forms S-2 or S-3 for subsequent registered public offerings.²⁸ As well, the failure to file a Form 8-K does not make Rule 144 of the Securities Act unavailable for the resale of restricted or controlled securities.²⁹

In promulgating Regulation FD, the SEC sought to protect “investor confidence in the integrity of our capital markets.”³⁰ Assuming that uninformed investors trading opposite to investors that enjoy a selective disclosure advantage will lose faith in the markets, the SEC argues that selective disclosures lead investors to “rightly question whether they are on a level playing field with market insiders.”³¹ The SEC notes in particular that managers may use the threat of curtailing selective

²³ See 17 C.F.R. § 243.100(e); see also 17 C.F.R. § 249.308 (2001) (Exchange Act Form 8-K).

²⁴ 17 C.F.R. § 243.100(e)(2).

²⁵ See 17 C.F.R. § 243.100(a)(1) (requiring simultaneous disclosure in case of intentional selective disclosure); see also 17 C.F.R. § 243.101(a) (stating that selective disclosure is intentional “when the person making the disclosure either knows, or is reckless in not knowing, prior to making the disclosure, that the information he or she is communicating is both material and nonpublic.”).

²⁶ See 17 C.F.R. § 243.100(a)(2) (requiring disclosure “promptly” in case of unintentional selective disclosures); 17 C.F.R. § 243.101(d) (defining “promptly”).

²⁷ See 17 C.F.R. § 243.102 (2001); see also SEC Promulgating Release, *supra* note 9, at *5. Instead, the SEC pursues public enforcement against such violations. See Michael Schroeder, *Raytheon's Disclosure to Analysts Is Investigated*, WALL ST. J., March 15, 2001, at A3 (reporting that SEC's investigation of Raytheon Corp. for violation of Regulation FD represents “the first test of the controversial SEC rule. . .”).

²⁸ See 17 C.F.R. § 243.103(a) (2001); see also 17 C.F.R. § 239.12 (2001) (Form S-2), 17 C.F.R. § 239.13 (2001) (Form S-3).

²⁹ See 17 C.F.R. § 243.103(b); see also 17 C.F.R. § 230.144(c)(1).

³⁰ SEC Promulgating Release, *supra* note 9, at *2

³¹ See *id.*

disclosures to force analysts to provide better than warranted recommendations on a corporation.³² However, not all managers may seek selfishly to benefit from selective disclosures. This Article, moreover, sets forth the argument that more narrowly tailored means exist to combat managerial opportunism.

II. SELECTIVE DISCLOSURES AND SHAREHOLDER-ORIENTED MANAGEMENT

Not all managers seek to expropriate value from shareholders. Managers may in fact act to maximize firm value to the benefit of shareholders for a number of reasons. State law fiduciary duties,³³ incentive compensation contracts,³⁴ ethical constraints,³⁵ and reputational concerns on the part of managers³⁶ all work to align the incentives of management and shareholders. Taking the perspective of overall investor welfare,³⁷ this Part makes the argument that selective disclosures to favored investors and analysts sometimes benefit investors as a group.³⁸

Section A presents the case that selective disclosures may benefit investors. However, selective disclosures may also result in overall harm to investors. Section B analyzes this potential harm. Distinguishing

³² See *id.*

³³ See, e.g., REVISED MODEL BUS. CORP. ACT § 8.30(a) (1985) ("A director shall discharge his duties as a director, including the duties as a member of a committee. . . in a manner he reasonably believes to be in the best interests of the corporation."); see also Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045 (1991) (providing law and economics analysis of fiduciary duties).

³⁴ See Richard H. Wagner & Catherine G. Wagner, *Recent Developments in Executive, Director, and Employee Stock Compensation Plans: New Concerns for Corporate Directors*, 3 STAN. J. L. BUS. & FIN. 5, 6 (1997) (noting that in recent years number of stock option plans for executives and directors has "exploded").

³⁵ Many business schools, for example, require students to enroll in business ethics courses. See Richard Donkin, *Business Ethics: the Rights and Wrongs*, FIN. TIMES, Oct. 9, 1997, at 4.

³⁶ Managers, for example, may seek to develop a pro-shareholder reputation to aid them in obtaining a better job or a promotion. Cf. Shuichi Senbongi & Joseph E. Harrington, Jr., *Managerial Reputation and the Competitiveness of an Industry*, 13 INT'L J. INDUS. ORG. 95 (1995) (predicting that managers produce more quantity than maximize profits in imperfectly competitive industries as means of increasing their reputation in managerial labor market).

³⁷ See *infra* note 98 (discussing importance of third party effects).

³⁸ Evidence exists that selective disclosures often have significant impacts on the securities markets. See Richard Frankel et al., *An Empirical Examination of Conference Calls as a Voluntary Disclosure Medium*, 37 J. ACCT. RES. 133 (1999) (providing evidence that issuer's conference call is often followed with abnormal trading volume and greater price volatility).

between when selective disclosures may benefit or harm investors, in turn, may require firm-specific knowledge. Where the incentives of managers are aligned with shareholders, Section C argues that managers are in a better position compared with outside regulators to determine when selective disclosures are, on net, beneficial for investors.

A. *The Beneficial Uses of Selective Disclosures*

Selective disclosures may result in a beneficial effect for investors for several reasons. First, recipients of selective disclosures benefit to the extent they are able to capture a higher return in their securities investments. Armed with inside knowledge about a particular traded company, an investor that receives selective information from a corporation can profit from trades against less well-informed investors.³⁹

Second, selective disclosures may result in more information reaching the market in a timely fashion, thereby increasing the accuracy of stock market prices.⁴⁰ Commentators have made the argument that without the ability to engage in selective disclosures, firms will simply stop making such disclosures altogether.⁴¹ A firm may have confidential

³⁹ Of course, the harm to the less well-informed investors must also be taken into account. Part II.B discusses the harms from selective disclosures.

⁴⁰ See *supra* note 6 (discussing how the stock market price may come to reflect information through securities trades). On the other hand, one preliminary study indicates no increase in stock-price volatility around earnings announcements after the promulgation of Regulation FD. See Frank Heflin et al., *Regulation FD and the Financial Information Environment* (Working Paper, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=276768 (last visited Nov. 29, 2001). Where Regulation FD substantially cut off the flow of information prior to an earnings announcement, one would expect more marked price reactions to the announcements, increasing price volatility. As well, the study found no evidence that the accuracy of analysts' forecasts declined in a statistically significant manner under Regulation FD. See *id.*

⁴¹ See, e.g., Letter from Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Feb. 24, 2000) (stating that "in our judgment [Regulation FD] will act as a significant chokepoint, discouraging companies from divulging important information."), available at <http://www.sec.gov/rules/proposed/s73199/kaswell1.htm> (last visited Nov. 29, 2001); Letter from Sullivan & Cromwell, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, (Apr. 28, 2000) (stating Regulation FD "may very well result in restricting, rather than enhancing, the flow of information to the public"), available at <http://www.sec.gov/rules/proposed/s73199/sulcrom1.htm> (last visited Nov. 29, 2001).

Evidence of the impact of Regulation FD to date has been sparse. See Allison Bisbey Colter, *Fund Firms Strengthen Research Teams*, WALL ST. J., Jan. 2, 2001 at C19 (noting that "The Securities and Exchange Commission's new fair disclosure rule has provoked much groaning on Wall Street as analysts, used to cozy ties with the companies they cover, encounter silence from corporate executives."); Cheryl Winokur Munk, *SEC Disclosure Rule Dims Appeal of Conferences*, WALL ST. J., Feb. 27, 2001, at C16 (reporting that Regulation FD

information that the firm cannot release to the broader market without reducing firm value. Release of confidential information that the firm plans to enter a new product market, for example, may allow competitors to expand production to deter such entry. Similarly, broad public disclosures may leave management and the disclosing company vulnerable to potential frivolous lawsuits based on the disclosures.⁴² Managers fearful of frivolous suits may prefer to release information to a select group of investors with well-known reputations for not engaging in non-meritorious litigation.⁴³

Once the option to make selective disclosures no longer exists, such managers may simply choose not to disclose. Despite Regulation FD's limited application to only material information,⁴⁴ firms uncertain as to the scope of the materiality definition under the securities laws may err on the side of non-disclosure.⁴⁵ More perniciously, firm managers may use Regulation FD as a shield to avoid discussion about negative

"has made companies less likely to share juicy tidbits in breakout sessions and in general presentations at these conferences" and thereby resulting in drop in attendance at investor conferences); Jeff D. Opdyke, *Rule of Fair Disclosure Hurts Analysts, House Subcommittee Is Told at Hearing*, WALL ST. J., May 18, 2001, at C15 (reporting results of Securities Industry Association survey that shows "69% of 'sell-side' analysts, those who produce buy and sell recommendations for brokerage firms, say Reg FD has adversely affected the advice they provide to clients. Meanwhile, the survey says just 14% of individual investors are making use of their newfound access to corporate conference calls and the like."); Jeff D. Opdyke & Michael Schroeder, *Disclosure Rule Gets a Bad Rap*, WALL ST. J., June 5, 2001, at C1 (reporting that "Campbell [Soup] continues to provide short-term guidance, albeit in a more-open setting. However, it has curtailed the long-term earnings guidance it once provided. Its executives won't answer privately asked questions designed to divine a more-specific short-term number or the possibility that the company will outperform or underperform — the guidance that many analysts often relied on in the past and that Reg FD specifically attacks.").

⁴² For evidence of non-meritorious securities litigation, see Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991); James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903 (1996).

⁴³ Some large investors, for example, may prefer to develop such a reputation to the extent they are able to access selective disclosures and gain an information advantage over uninformed investors in the market.

⁴⁴ See 17 C.F.R. § 243.100(a) (2001).

⁴⁵ See SEC Promulgating Release, *supra* note 9, at *10 (noting that commentators have made argument that materiality definition under securities laws "was too unclear and complex a standard for issuer personnel to use in making 'real time' judgments about disclosures, and that this vagueness would lead to litigation and a chilling effect on corporate disclosure practices."). Firms that do not err on the side of non-disclosure, in the alternative, may then face a heightened risk of an SEC enforcement action. Cf. Phyllis Plitch, *Motorola Says Private Discussions With Analysts Aren't "Material"*, WALL ST. J., Aug. 24, 2001, at B2 (noting uncertainty about whether Motorola's disclosures to analysts were material).

company-related information.⁴⁶ Regulation FD also may retard the ability of managers to engage in low-cost, flexible disclosures with investors.⁴⁷

The increased accuracy of securities prices resulting from selective disclosures, in turn, provides several benefits for the disclosing company and its investors (in addition to third parties that rely on accurate securities prices).⁴⁸ To the extent a company's share price is more accurate, executives compensated through stock options and other forms of compensation based on the share price bear less risk. Companies with more accurate securities prices, as a result, may pay a lower overall level of compensation to their executives, all other things being equal.⁴⁹ Companies with more accurate securities prices may also utilize their securities to fund an acquisition using a lower total dollar amount of securities.⁵⁰ Greater corporate value then results in a higher stock price that, in turn, benefits the shareholders indirectly.

⁴⁶ See David Greising, *Disclosure Rule Giving Firms Place to Hide*, CHI. TRIB., Apr. 25, 2001, at Bus. 1 (reporting that company executives may invoke Regulation FD to avoid discussion on negative information related to company).

⁴⁷ See Johanna Bennett, *Euro Weakness Expected to Hurt Results at Medical Device Firms*, WALL ST. J., Jan. 16, 2001, at B6 (quoting SG Cowen analyst Matt Dodds as stating that "Regulation FD, I think, has made it harder for people to make changes [in estimates] proactively. . . It's a reflection of no longer being able to give intraquarter guidance so the numbers slide down at the end of the quarter."); Raymond Hennessey & Phyllis Plitch, *SEC Becomes Repository of Small Fixes: New Disclosure Rule Has Firms Filing to Correct Typos and Sloppy Math*, WALL ST. J., June 5, 2001, at B11E ("In the past, 'it was much more touchy feely,' says Raphael Soifer, a former securities industry analyst and now an independent consultant. 'Today, when a senior executive such as a chairman gives a presentation, it's a public occasion. Therefore, if, as frequently happens, executives don't always get the facts exactly right, then someone on the staff has to put out a public clarification because the statement itself was made public.'). See *infra* note 98 (discussing importance of third party effects).

⁴⁸ See *infra* text accompanying notes 98-102 (discussing importance of third party benefits from accurate securities prices). For a general discussion of the benefits from accurate securities prices, see Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L. J. 977 (1992). Kahan distinguishes among different forms of market inaccuracies based on the cause, manifestation, and scope of the inaccuracy. See *id.*

⁴⁹ Alternatively, such companies may pay their executives with a greater fraction of equity-based compensation, enhancing the incentives of the executives to maximize firm value.

⁵⁰ Target companies will demand a greater amount of an acquiring company's stock as compensation in situations where the share price of the acquiring company is more inaccurate and therefore volatile. On the one hand, diversified shareholders of target companies may not care about unsystematic volatility. In contrast, however, managers of target companies may care to the extent their individual reputations will depend on the amount they ultimately receive for the sale of their companies and the managers personally hold large, undiversified equity stakes in the target company.

More accurate securities prices also reduce the mispricing risk facing investors. An investor that purchases shares in a particular company faces the risk that the shares may be either under- or overvalued. Investors, therefore, will demand a discount for the variance in value for the securities they purchase. Investors that hold portfolios of diversified stock, on the other hand, may not suffer a loss from a decrease in price accuracy across their portfolio to the extent the mispricing is not systematic.⁵¹ Nevertheless, not all investors hold diversified portfolios. Managers compensated through restricted stock or stock options, for example, are undiversified in their company's stock.⁵² Speculative traders may also take large positions in a particular security.⁵³ In addition, the mispricing risk may be systematic and therefore impact the returns of even diversified shareholders. To the extent negative forces in the economy affect a number of different companies in a similar manner, the market may simultaneously overvalue all such companies.⁵⁴

Third, firms may also use selective disclosures to compensate analysts and large block shareholders for engaging in shareholder-wealth increasing activities. Analysts, for instance, may undertake to assess regularly the value of a corporation and transmit this information to the general investing public. This assessment may combine both material and immaterial information obtained from the company as well as other information sources at the analyst's disposal. Such information may help increase the accuracy of the share price, reducing the mispricing risk facing the company's investors.⁵⁵

⁵¹ Put another way, unsystematic risks are averaged out in a diversified portfolio. Modern portfolio theory assumes that rational investors will hold diversified portfolios and therefore that only systematic risks affect securities prices. See, e.g., RICHARD BREALEY & STEWART MEYERS, *PRINCIPLES OF CORPORATE FINANCE* 153-56 (5th ed. 1996).

⁵² For a description of executive compensation stock option plans, see Eric L. Johnson, Note, *Waste Not, Want Not: An Analysis of Stock Option Plans, Executive Compensation, and the Proper Standard of Waste*, 26 J. CORP. L. 145 (2000).

⁵³ In contrast, some commentators have argued that policymakers should focus more on educating investors to diversify their portfolios rather than provide any substantive protections for the undiversified. See, e.g., Fox, *supra* note 21, at 672 ("As for helping investors who are not diversified, it is probably better public policy to engage in an educational campaign urging them to start diversifying than it is to pass a rule, with its inevitable administrative costs, to protect them against just one among the thousands of unsystematic risks affecting their investments, all of which diversification can eliminate.").

⁵⁴ In contrast, Marcel Kahan argues that firm-specific information will not reduce systematic volatility in the market to the extent such volatility is due to "liquidity crunches, overreaction to information, or market-wide speculative trading". See Kahan, *supra* note 48, at 1003. Nevertheless, firm-specific information from a range of different companies may provide an analyst with a greater ability to predict systematic shifts in the overall economy or the companies' specific industry.

⁵⁵ Zohar Goshen and Gideon Parchomovsky also recognize that selective disclosures

Analysts, of course, can obtain compensation for their information research through proprietary trades as well as through fees, which other investors pay the analysts for the information.⁵⁶ Nevertheless, analysts may not provide the level of coverage that shareholders of a particular company as a group may desire. Once an analyst releases information to a subset of the investment community, the information may flow rapidly to the rest of the general public market. Analysts may therefore fail to recoup the full benefit from their information production.⁵⁷ On the other hand, the value of information in the trading markets diminishes rapidly.⁵⁸ Even with the rapid dissemination of information, therefore, analysts may retain significant profits from proprietary trading and the sale of the information to others. Analysts may also face a fixed cost in engaging in information research for any particular company. An analyst encountering a range of relatively small, unknown companies may fear that she may expend the fixed cost in learning about a particular company only to find that the company is a poor investment and offers little future growth potential. Small companies with a strong growth potential may then help signal their value and subsidize analysts for making a fixed cost investment in initiating coverage through a policy of selective disclosures to the analysts.

Large block shareholders may also provide beneficial services for smaller shareholders. Block shareholders, for example, may monitor management for agency problems.⁵⁹ Once an investor owns a block, the investor will have greater incentives to make expenditures in investigating the performance of a company's management.⁶⁰ The block

may play a role in compensating specific analysts for providing the firm with monitoring of management, liquidity, and enhanced price efficiency. See Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and "Negative" Property Rights in Information*, (forthcoming *Virginia Law Review*, 2001).

⁵⁶ In addition, an analyst may indirectly earn fees in the form of broker's commissions as investors that wish to access a particular broker-analyst's information choose to establish brokerage accounts with the broker-analyst. Merrill Lynch, for example, provides extensive research reports on-line at its internet web site to investors that invest through Merrill Lynch. See <http://www.ml.com> (last visited Jan. 28, 2001).

⁵⁷ For a discussion of the public goods nature of information, see Goshen & Parchomovsky, *supra* note 55.

⁵⁸ See Gilson & Kraakman, *supra* note 6, at 570 (noting that "it seems plausible that the relative efficiency of price adjustment to new information that proceeds through professionally informed trading declines only gradually as initial access to the information narrows to a threshold minority of traders, after which it declines rapidly.").

⁵⁹ See Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 *CARDOZO L. REV.* 1033, 1062-63 (1994) (arguing that block shareholders with long-term relation with management may serve to monitor for agency problems and help implement optimal implicit contractual arrangements).

⁶⁰ See Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 *J.*

investor may also have a greater ability to influence management through its voting power. Large block shareholders also increase the likelihood of an outside takeover. Potential acquirers, for example, may be more inclined to investigate a particular company as an acquisition target where the acquirer knows that a large block of shares exists that may facilitate the takeover of the firm. To the extent assembling a block is costly, time consuming, and hard to keep confidential, a potential acquirer may more easily establish a large position in a firm through the purchase of a pre-existing non-control block.⁶¹ Alternatively, the block shareholder itself faces a reduced cost to obtain control over the firm. Compared with other outside investors, the block shareholder only needs to purchase the incremental number of shares sufficient for control. An increased risk of a takeover, in turn, disciplines managers against engaging in self-dealing opportunistic behavior.

Assembling a large block of shares moreover is costly and such costs may increase with the size of the block. Put another way, potential block shareholders face an upward sloping supply curve for shares.⁶² Shareholders, for instance, may hold a range of expectations as to share value.⁶³ Parties assembling a block of shares will first purchase from those parties that value the shares the least. As more shares are purchased and assembled into a block, the marginal price to purchase shares will increase as the block shareholder must purchase from

POL. ECON. 461, 465-66 (1986) (noting that large block shareholders have greater incentives than small dispersed shareholders to monitor managers for agency problems).

The level of block shareholder monitoring of management may vary across countries. In Canada, for example, block shareholders typically are more concentrated than in the United States and take a much more active role in corporate activities. *See, e.g.,* Ramzi Nasser, *The Morality of Insider Trading in the United States and Abroad*, 52 OKLA. L. REV. 377, 404 (1999).

⁶¹ In particular, the Williams Act requires shareholders that beneficially own more than five percent of an Exchange Act reporting company's stock to file a public disclosure document with the SEC. *See* 15 U.S.C. § 78m(d)(1) (1994). A potential acquirer purchasing from dispersed shareholders may then purchase only up to 5 percent of a target's stock without revealing its position to the market. Revelation to the market, moreover, may signal an impending takeover, raising the stock price and the cost to the potential acquirer of obtaining additional shares. The potential acquirer, therefore, may find it cheaper instead to negotiate with a pre-existing block holder to purchase the block. While the block shareholder will also demand part of the potential acquirer's anticipated gain from the takeover, the block shareholder will take into account the possibility that if it does not sell, the potential acquirer may choose not to go forward with the takeover.

⁶² *See infra* note 72 (discussing possibility of upward sloping supply curve for shares).

⁶³ For a discussion of the possibility that investors may hold heterogeneous expectations with respect to share value, see Hirshleifer, *supra* note 3, at 567; Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 741-51 (1999).

investors with increasingly higher valuations of the company. Alternatively, shareholders may bear different exposure to taxes when they sell their shares.⁶⁴ Faced with the choice between holding on to their shares and delaying tax consequences and selling their shares with immediate tax consequences, shareholders with a reduced tax burden will be more likely to sell at a lower price. As a larger block is assembled, potential block shareholders must purchase shares from investors with increasingly greater negative tax consequences who demand compensation in the form of a higher share purchase price. In addition, the very act of purchasing a block of shares may signal to the market that a potential takeover is more likely. The more shares that are purchased, the greater the signal and the higher the price subsequent investors selling their shares will demand.⁶⁵ Block shareholders also bear the cost of owning an undiversified block of securities.

While a block shareholder bears the full costs of assembling the block and monitoring managers, it receives only part of the benefit from monitoring management for opportunism. All shareholders benefit as management's incentives are aligned with those of shareholders. Outside investors contemplating putting together a block of shares will ignore the benefit to other shareholders. From the point of view of a company's shareholders as a group, therefore, the outside investor may have too low incentives to construct a block of shares and monitor managers. One may question whether managers seeking to engage in opportunism would ever subsidize the formation of a block of shares to monitor the managers. Nevertheless, two responses are possible. First, a firm *ex ante* may establish a policy of providing selective disclosures based on objective criteria (such as the size of the block of shares) when the firm initially goes public to raise the price investors may be willing to

⁶⁴ Different investors under U.S. tax laws may face varying tax consequences from selling common stock. Individual investors that hold onto their shares for at least one year may receive long-term capital gains preference for any realized gain. Individual investors that hold their shares for less than one year are taxed based on their marginal ordinary income rate for any realized gain when they sell their shares. *See generally* WEST FEDERAL TAXATION: INDIVIDUAL INCOME TAXES ch. 16 (2001 ed. 2001) (providing discussion of capital gains and losses under federal income tax). As well, corporate shareholders are always taxed at their relevant corporate rate when they sell shares. *See* I.R.C. § 11 (2001). Finally, non-profit organizations are not taxed at all on realized gains when selling shares. *See* I.R.C. § 501(c)(3) (2001).

⁶⁵ *See* Arturo Bris, *When do Bidders Purchase a Toehold?* (Working Paper, 1998), (presenting evidence from sample of tender offers from 1985 to 1998 that assembling toehold prior to bid signals to market possibility of takeover and thereby may lead to run-up in secondary market price), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=139824 (last visited Nov. 29, 2001).

pay for the firm's shares.⁶⁶ Second, even in the midstream, managers of firms that wish to signal their pro-shareholder orientation as a means of raising share price may seek to induce the formation of a block of shares to monitor the managers.

A firm may therefore increase overall shareholder welfare through a selective disclosure policy designed to subsidize analysts and large block shareholders. A firm, for example, could make known to the market that it provides selective disclosures to those block shareholders owning above a specified minimum percentage of outstanding common stock. The firm could also specify that only analysts advising clients with over a certain minimum amount of investment funds will receive selective disclosures. The firm could either make a formal announcement of such a policy or else follow a repeated pattern of such selective disclosures to develop a reputation of engaging in such disclosures. The possibility of selective disclosures may then induce outside investors to construct a block of shares to capture the above market return from the information advantage related to the disclosures.⁶⁷ Similarly, analysts may choose to make the necessary fixed cost investments to initiate coverage of the disclosing firm.

B. The Harm from Selective Disclosures

Even where selective disclosures benefit investors through an increase in the amount of information in the market, resulting in greater price accuracy, such disclosures may also impose a cost on uninformed investors. In addition, managers may use selective disclosures opportunistically, thereby reducing overall value for investors. Such abuses by management fueled the SEC's reform attempts and resulted in the SEC's enactment of Regulation FD.⁶⁸

The first problem that uninformed investors face is the possibility of suffering systematically reduced returns as they trade against investors that enjoy a selective disclosure advantage. Consider the following hypothetical involving Kernel Inc., a fictitious publicly-traded manufacturer of Texas mesquite flavored popcorn. Kernel has a range of shareholders, including one large block shareholder, Graham

⁶⁶ For a discussion of the possibility of basing selective disclosures on class-based criteria, see *infra* Part IV.B.

⁶⁷ *But see* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV.10, 26-27 (1991) (noting variety of legal impediments facing shareholders that desire to build up large block of shares).

⁶⁸ *See supra* text accompanying notes 30-32.

Investments, and a wide range of smaller shareholders.⁶⁹ Among the smaller shareholders are a significant number of individual investors each with a relatively small dollar amount of Kernel securities in their portfolios. Suppose that Kernel has non-public material information that its next quarter earnings will fall short of public projections. Where Kernel discloses this information solely to Graham, Graham will then enjoy an information advantage over the rest of the market. Graham may then take advantage of this information, reducing its block shareholdings or selling Kernel's securities short into the market.⁷⁰

Traders that purchase securities from Graham that otherwise already planned to purchase the securities will not be harmed.⁷¹ On the other hand, Graham's sales may contribute to a decrease in the market price of Kernel's securities, either as a response to the signal that Graham's sales transactions provide the market or through price pressure.⁷² Uninformed shareholders that may have sought to sell the securities at the prior market price may choose not to do so as the price drops, holding onto securities the shareholders now believe to be undervalued (given their lack of information).⁷³ More active traders without Graham's information advantage may also believe that Kernel's stock is undervalued as the price drops and choose to purchase Kernel's securities, thereby experiencing reduced returns.⁷⁴ Note that even where the harm nominally falls on active traders (without any present Kernel

⁶⁹ For an invaluable introduction to investment principles, see BENJAMIN GRAHAM & DAVID L. DODD, *SECURITY ANALYSIS: THE CLASSIC 1934 EDITION* (1996).

⁷⁰ Short sales involve the sale of securities that the seller does not own. Instead, the seller first borrows stock from a broker and sells the borrowed stock into the securities market. The seller must later "repay" the broker with stock of the same company purchased in the market. To the extent the stock price drops from the time the seller borrows the stock to the time the seller purchases replacement securities, the seller profits from the short sales.

⁷¹ See William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1241-45 (1981).

⁷² The price pressure view of securities market pricing holds that an upward sloping supply curve exists for shares. With an upward sloping supply curve, greater demand will result in higher prices for shares. Similarly, an increase in supply as Graham sells shares will shift the supply curve outward, resulting in lower prices. For a discussion of empirical studies demonstrating an upward sloping supply curve for shares, see Jesse M. Fried, *Insider Signaling and Insider Trading With Repurchase Tender Offers*, 67 U. CHI. L. REV. 421, 434-35, 434-35 n.65-67 (2000).

⁷³ See *id.*

⁷⁴ See, e.g., William K.S. 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*, 45 VILL. L. REV. 27, 29-40 (2000) (noting that when insider benefits from insider trading someone necessarily must lose).

holdings) that purchase Kernel stock from existing Kernel shareholders, the active traders, to the extent rational, will demand a discount to compensate for the expected harm. Where the active traders cannot distinguish among different sellers of Kernel securities, the active traders will demand the discount from *all* Kernel shareholders, shifting the cost derived from informational disparities to the group of Kernel's shareholders.

In the alternative, market makers that hold themselves out as continuously willing to buy and sell securities may purchase securities directly from Graham and thereby also suffer a systematic reduction in expected returns. Market makers may then respond through an increase in the bid-ask spread as compensation, again shifting the cost of Graham's information advantage onto Kernel's shareholders.⁷⁵ An argument exists that Kernel's shareholders only partly bear the cost of a high bid-ask spread — the other transacting party (possibly a non-shareholder) also bears the cost. Non-Kernel shareholders that seek to purchase securities, however, will take into account the higher expected bid-ask spread when they eventually sell their securities and demand a higher upfront discount from the Kernel shareholders.

Second, the ability to engage in selective disclosures may not necessarily increase the accuracy of securities prices. Some firms may react to the selective disclosure ban under Regulation FD with *greater* overall disclosure to the entire market; the market may impose too great a discount on firms that fail to make such disclosures.⁷⁶ Smaller, more uninformed investors may then benefit from greater access to firm-specific information from the disclosing company.⁷⁷

⁷⁵ Market makers obtain a return for the liquidity service they provide through the bid-ask spread. To the extent market makers face the possibility of increased trading losses due to the presence of traders with an information advantage stemming from selective disclosures, the market makers will increase the bid-ask spread to compensate for the losses. *See, e.g.,* Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985); Albert Kyle, *Continuous Auctions and Insider Trading*, 53 ECONOMETRICA 1315 (1985).

⁷⁶ *See, e.g.,* Response from United Kingdom Listing Authority to Securities and Exchange Commission Proposed Rule on Selective Disclosure Regulation FD (Mar. 28, 2000) (comparing Regulation FD to similar regulations in United Kingdom and stating that "[o]n balance, we do not believe that Regulation FD will seriously 'chill' the flow of corporate information. Our equivalent regulation does not appear to have had this effect and commercial factors will ensure that issuers will still find it necessary to brief analysts and institutional investors. Those same commercial pressures will encourage the briefings to be as frank as practicable."), *available at* <http://www.sec.gov/rules/proposed/s73199/ukla1.htm>.

⁷⁷ On the other hand, prior to the promulgation of Regulation FD, companies already were opening up their conference calls with analysts to all investors through the internet. *See* Review & Outlook, Editorial, WALL ST. J., Dec. 17, 1999, at A14 (noting that "[m]ore

Finally, even managers acting in the best interests of their present shareholders may use selective disclosures to “bribe” analysts to give higher than warranted ratings on their company’s stock, threatening to cut off the supply of selective disclosures for analysts that fail to give high ratings.⁷⁸ To the extent the market price reacts to the recommendations of analysts, the ability to engage in selective disclosures may therefore affirmatively reduce the accuracy of stock market prices.⁷⁹ Of course, rational investors that realize that selective disclosure bribes from management may result in higher than warranted analyst ratings will discount such ratings.⁸⁰ To the extent at least some analysts are truthful in their opinions and the market is unable to distinguish among truthful and corrupted analysts perfectly,⁸¹ some corrupt analysts nevertheless may be successful in fooling the market. Rational purchasers of securities that realize this possibility will then demand a discount of all firms.⁸²

For investors that hold diversified portfolios, the possibility of corrupt analysts only shifts value from some companies (those that do not bribe

than half of companies already let individual investors listen in on conference calls with analysts, up from 30% last year.”). Investors, for example, may listen to Symantec Inc.’s conference calls on the Internet. Information on web broadcasts of Symantec’s conference calls to analysts may be found at <http://www.symantec.com/invest/events.html> (last visited Dec. 29, 2000).

⁷⁸ See Selective Disclosure and Insider Trading, Exchange Act Release No. 34-42259 (proposed Dec. 20, 1999) (to be codified at 17 C.F.R. parts 230, 240, 243, 249), 1999 WL 1217849, at *4 [hereinafter SEC Proposing Release] (“[A]nalytsts are likely to feel pressured to report favorably about particular issuers to avoid being ‘cut . . . off from access to the flow of non-public information through future analyst conference phone calls’ or other means of selective disclosure.”).

⁷⁹ But see Fox, *supra* note 21, at 677 n.71 (noting that “[t]he analyst’s capacity to make credible recommendations depends on not engaging in distortions.”). Fox, nevertheless, goes on to note that analysts “make positive recommendations in order to improve relations between the issuer being analyzed and the investment banking arm of the firm for which the analyst works.” *Id.*

⁸⁰ See *id.* at 678 n.72 (“To the extent that a convention develops for analysts as a general matter to say more positive things about issuers than negative ones, the market, in the inferences it draws from analyst recommendations, is certainly capable of correcting for this bias.”).

⁸¹ Disclosure with respect to a company’s selective disclosure policies as well as rules designed to limit the ability of managers to terminate the flow of selective disclosures once started may alleviate such concerns, allowing investors to distinguish analysts more likely to fall under the influence of managers. For a discussion of such proposals, see *infra* Part IV.

⁸² Although rational purchasers may lack information on the precise companies that bribe analysts to increase their ratings, on average rational purchasers should be unbiased in their prediction of the average impact of such bribes on the market price and should therefore discount their willingness to pay such that on average the purchasers continue to earn at least zero economic profits from their investment.

analysts) to others within their portfolios (those that do bribe) without increasing the total value of their portfolio.⁸³ Managers that seek to maximize the value of diversified shareholders, therefore, will not seek to bribe analysts. Managers, nonetheless, may still seek to maximize their firm's share price through bribes to analysts to the extent non-diversified shareholders are present or, as discussed later in the Article, managers stand to gain personally from a share price increase (for example, where managers own a large, undiversified interest in their own company). Despite the possibility of analyst corruption, the reforms proposed in Part IV to combat managerial opportunism also work to reduce the pressure managers may place on analysts even when motivated out of a desire to maximize share price for their own shareholders.⁸⁴ Firms that are able to commit publicly (through this Article's proposals) not to coerce analysts through selective disclosures will enjoy a higher initial offering price (to the extent purchasing investors will expect subsequent purchasers not to discount the value of the firm's shares for coerced analyst recommendations).⁸⁵

C. Regulatory Responses to Selective Disclosures

As the proceeding sections discussed, whether selective disclosures result in net benefits or harms to investors is indeterminate. For some firms, selective disclosures may increase the risk facing uninformed investors prohibitively, reducing overall investor welfare. Investors in the market may then lose confidence, reducing the overall liquidity in the market. Indeed, the SEC cites the protection of investor confidence in

⁸³ For example, imagine that three companies A, B, and C are in the market. An investor holds one share in each company. The fundamental value of each company is \$100 per share. However, company A is successful in coercing a higher than warranted analyst rating, increasing its share price initially to \$130. Purchasers that realize that some companies may enjoy the advantage of corrupt analysts (but not knowing those precise companies), will then demand a discount of \$10 per share for all the shares they purchase. The market price for B and C will then drop to \$90 while the market price for A will drop to \$120. Note that despite the shift in share values, the investor that owns equal shares in A, B, and C then has a total value of \$300 across the three shares.

⁸⁴ See *infra* Part IV. Managers may also seek to adjust the timing of disclosure as well as the types of investment projects in which a firm engages to increase the value of selective disclosures. To the extent such activities reduce overall shareholder welfare; however, managers that seek to maximize shareholder wealth will choose not to do so. Nevertheless, managers that act opportunistically may engage in such activities. See *infra* text accompanying note 119.

⁸⁵ Put another way, this Article's proposals provide a mechanism for different firms to both control their own selective disclosure policy and communicate this policy to the market. The market, therefore, will have a greater ability to distinguish among more credible and less credible analyst recommendations for specific companies.

the capital markets as a primary motivating force behind Regulation FD.⁸⁶ In addition, where selective disclosures result in only unambiguous net losses for investors, prohibiting such disclosures clearly benefits overall investor welfare. However, for firms under other circumstances, selective disclosures may actually work to increase overall price accuracy and also help induce analysts to cover the firm, among other beneficial impacts.

The key point of this Part is therefore not that all selective disclosures are *per se* beneficial for investors. Rather, the section only argues that selective disclosures may, under plausible circumstances, benefit investors. Whether selective disclosures result in an overall benefit for investors is dependent upon a balance between the increase in accuracy and other benefits from the disclosures (including the subsidization of analyst coverage and the formation of blocks of shares) and the systematically lower returns that uninformed investors receive (as well as information dissemination costs to the firm making the selective disclosure).⁸⁷ This balance, moreover, may vary based on a corporation's particular circumstances. A selective disclosure that must remain confidential for only a short-time period and that will soon be released generally into the market results in only a minimal benefit from the increase in accuracy of the market price.⁸⁸ At the same time, such a selective disclosure may provide the favored investors with substantial trading profits at the expense of a company's general shareholder population.

⁸⁶ See SEC Proposing Release, *supra* note 78, at *3 ("We are troubled by the many recent reports of selective disclosures and the potential impact of this practice on market integrity . . . promoting investor confidence in the fairness of our securities markets is an 'animating purpose' of the Exchange Act. Clearly, one critical component of that mission is protecting investors from the prospect that others in the market possess 'unerodable informational advantages' obtained through superior access to corporate insiders."); SEC Promulgating Release, *supra* note 9, at *2 ("We believe that the practice of selective disclosure leads to a loss of investor confidence in the integrity of our capital markets. Investors who see a security's price change dramatically, and only later are given access to information responsible for that move, rightly question whether they are on a level playing field with market insiders.").

⁸⁷ Information dissemination costs include not only the costs of producing and transmitting the information but also the cost to the firm from the reduction in confidentiality of the information released. Even where a recipient promises to keep the information confidential, for example, the risk of disclosure increases with the number of outside parties that know of the information.

⁸⁸ See, e.g., Kahan, *supra* note 48, at 981; see William K.S. Wang, *Selective Disclosure by Issuers, It's Legality and Ex Ante Harm: Some Observations in Response to Professor Fox* (Working Paper, 2001) (on file with author) (noting that value of increased price accuracy from informed trades may not be great if time interval between informed trades and public dissemination of information is short).

The question then becomes who should make the decision on when to allow selective disclosures. Significantly, the traded firm already internalizes many — although not all — of the impacts from informational disparities where the firm itself is the source of the information.⁸⁹ Where Kernel's investors expect to suffer a reduced return due to informational disparities in the market, they will demand an increased discount from Kernel at the time they purchase their securities.⁹⁰ Similarly, to the extent trades based on informational disparities help increase the accuracy of Kernel's stock price, diminishing the mispricing risk facing investors, then investors will demand a *reduced* discount from Kernel when they initially buy their shares. Kernel will therefore directly take into account not only the costs of disseminating information but also the trading loss to its own uninformed investors and the gain to its uninformed investors from increased stock price accuracy due to selective disclosures (as well as accuracy benefits from inducing analysts to initiate coverage of the firm).⁹¹ From the viewpoint of overall investor welfare, however, Kernel, at first glance, fails to take into account the trading gains to the recipient of the selective disclosures.⁹²

⁸⁹ The argument for internalization of the impacts from selective disclosures track the arguments Henry Manne put forth many years ago for a *laissez faire* approach to insidetrading. See HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966). Unlike for insider trading, however, the prospect of managerial opportunism through selective disclosures are more readily addressed. See *infra* Part IV (providing variety of regulatory options to curtail opportunistic selective disclosures).

⁹⁰ For a review of securities law literature that makes a similar reference to the ability of investors to demand a discount for the risks they face, see Fox, *supra* note 21, at 670 n.59. Graham, of course, and other investors that believe that they will enjoy an information advantage may demand a *reduced* discount that balances out the increased discount the uninformed investors demand when they initially buy their shares from Kernel. To the extent Kernel is limited to offering shares at only one price, however, Kernel (assuming it seeks to sell a fixed amount of securities) must cater to the marginal prospective shareholder — e.g., the prospective uninformed shareholders. Public offerings within the United States, for example, are required under federal securities laws to sell at only one fixed price. See 17 C.F.R. § 229.501(b)(3) (2001) (Regulation S-K); 17 C.F.R. § 239.11 (2001) (Exchange Act Form S-1).

⁹¹ Firms will also internalize the benefit to its investors from inducing a large block shareholder to monitor the firm's managers. At the time the firm offers securities to the market, for example, investors will be willing to pay more for the securities to the extent they expect a large block shareholder to form and actively monitor managers. For a more detailed discussion of the various impacts from informational disparities in the securities markets, see Ian Ayres & Stephen Choi, *Internalizing Outsider Trading* (Working Paper, 2001) (on file with author).

⁹² As discussed above, other possible benefits and costs from selective disclosures are possible. First, third parties are affected from a change in the accuracy of securities prices. See *infra* text accompanying notes 99 – 102. Second, firms may also use selective disclosures to corrupt analysts and large block shareholders. See Part IV for reforms that address

For example, suppose that Kernel grants Graham a selective disclosure advantage that results in a \$100 trading profit for Graham (and a corresponding \$100 trading loss for uninformed shareholders of Kernel).⁹³ Also assume that Graham's transactions will result in an increase in the accuracy of Kernel's securities worth \$30 to Kernel's investors.⁹⁴ Kernel will directly take into account only the \$100 trading loss to its shareholders and the \$30 gain due to the accuracy benefit (for a total loss of \$70). Kernel, in particular, may ignore Graham's \$100 trading profit from the selective disclosure.⁹⁵ Without more, Kernel will choose not to make the selective disclosure even though overall investor welfare is increased from the disclosure (by a net \$30 in the example).⁹⁶

Nevertheless, the very act of a selective disclosure necessarily implies that Kernel is in direct contact with Graham Investments. Kernel, to the extent Kernel's managers seek to maximize share value, will grant Graham the ability to receive \$100 additional trading profits only to the extent Graham provides Kernel (or Kernel's shareholders) sufficient value in return. Indirectly, therefore, Kernel internalizes the benefit from selective disclosures that Graham receives. Kernel will make the decision to provide Graham the ability to profit by \$100 only to the extent it can recoup the net \$70 loss it suffers from the provision of such information (equal to the \$100 trading loss minus the \$30 increase in accuracy from the trades). Internalization occurs when Graham agrees

explicitly the problem of corruption through selective disclosures.

⁹³ Note that the \$100 loss to Kernel's uninformed shareholders occurs regardless of whether Graham Investments is purchasing or selling Kernel's securities. Where Graham purchases undervalued Kernel securities, Kernel's uninformed shareholders that sell are directly harmed. On the other hand, where Graham sells overvalued Kernel securities, non-Kernel securities holders may buy the securities. Nevertheless, to the extent rational, the non-Kernel securities holders will require a discount for the possibility that they are purchasing overvalued securities from a party with an information advantage. Where the non-Kernel securities holders are unable to distinguish among selling parties, they will require this discount from all the selling parties. Thus, even uninformed Kernel shareholders will expect to receive such a discount when they eventually sell their securities, leading them to internalize the loss to the non-Kernel securities holders from Graham's informed trades.

⁹⁴ For now, abstract from possible third party benefits from increased share price accuracy.

⁹⁵ Note, where Kernel in fact is able to sell securities at differential prices, it may be able to sell securities to Graham at a higher price to take into account Graham's future selective disclosure advantage. Nevertheless, as discussed in note 90, issuers face a fixed price rule when they engage in a public offering. Moreover, Graham and other recipients of selective disclosures may not be present shareholders in Kernel.

⁹⁶ The net \$30 benefit is equal to the \$100 trading profit to Graham minus the \$100 trading loss to uninformed investors plus the \$30 benefit from increased share price accuracy.

to transfer value to Kernel or Kernel's shareholders in return for the selective disclosure (which Graham will be willing to do up to a cost of \$100 equal to the \$100 trading profits Graham obtains from using the selective disclosure). For example, where Graham will initiate analyst coverage of the company, providing \$100 additional benefits to Kernel's investors, Kernel may then choose to make selective disclosures to Graham.

Where managers act in the best interests of shareholders, managers will employ a selective disclosure policy that best maximizes overall investor welfare. To do this, managers will balance: (1) the cost of information production, (2) the trading gain to the investor receiving the selective disclosure (to the extent the receiving investor compensates Kernel for the selective disclosure), (3) the trading loss to Kernel's own uninformed shareholders, and finally (4) the increase in accuracy in Kernel's stock price. This Article therefore contends that where managers act in the best interests of their shareholders, no compelling reason exists to prohibit selective disclosures. Thus, Regulation FD's largely untailed scope sweeps too broadly. Lacking good information on the relative costs and benefits of selective disclosures for a particular firm in any given situation, regulators are left only with the blunt ability to implement an outright ban of selective disclosures as under Regulation FD.⁹⁷ The disclosing firm, in contrast, internalizes most of the impacts from disclosure and therefore acts as a better decision maker than the government in deciding when to allow selective disclosures. Managers, of course, may not work in the best interests of their shareholders but rather for the managers' own welfare. The next Part discusses the possibility of managerial opportunism.

In considering the value of selective disclosures from the perspective of overall investor welfare (and indeed societal welfare), regulators must also consider the effect on third parties not connected with the disclosing company. Even when managers act in the best interests of the disclosing company's shareholders, selective disclosures may have consequences on investors not necessarily connected with the disclosing company. Disclosures that increase share price accuracy, for example, may benefit

⁹⁷ In the context of insider trading regulation, David Haddock and Jonathan Macey make a similar point that insider trading prohibitions sometimes benefit outside shareholders and other times do not. See David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1451 (1987). Given the variable desirability of insider trading prohibitions and assuming that outside shareholders are able to distinguish among such situations, Haddock and Macey argue that insiders and outside shareholders should have the ability to contract for whatever level of insider trading prohibition they desire, including the complete repeal of such prohibitions. See *id.*

non-shareholder investors among other groups.⁹⁸ Competitors may look to the share price of a company to determine whether to enter into a new product market that the company presently occupies. More generally, disclosures from one firm may have an impact on both the pricing of other companies' securities and the business decisions of the other companies.⁹⁹

Nevertheless, the magnitude of the benefit to third parties from increased share price accuracy is unclear. Without regard to third parties, companies already disclose a large amount of information voluntarily to reduce the mispricing for their own investors. Companies that fail to do so are subject to a large discount at the time they sell securities to the market. Issuers in Europe, for example, typically will adopt U.S.-style disclosures voluntarily not out of a concern for third parties but to satisfy the demands of their own investors.¹⁰⁰ It is also unclear to what extent the SEC presently takes into account the impact on third parties in its regulatory decisions (including especially non-investor constituencies such as labor that may value accurate securities prices).¹⁰¹ As with all regulatory agencies, the SEC is subject to public choice pressures and a lack of expertise.¹⁰² Therefore, managers with

⁹⁸ Indeed, non-investors may benefit from increased securities price accuracy. Merritt Fox puts forth the argument that labor, among other groups, benefit from more accurate securities prices for domestic companies. See Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2562-2569 (1997). But see Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387, 420-64 (2001) (arguing that interfirm externalities does not justify mandatory information disclosure).

⁹⁹ See James D. Cox, *Rethinking U.S. Securities Law in the Shadow of International Regulatory Competition*, 55 LAW & CONTEMP. PROBS. 157, 188 (1992); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 685-87 (1984); George Foster, *Externalities and Financial Reporting*, 35 J. FIN. 521, 523-25 (1980); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1345 (1999).

¹⁰⁰ See Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence From Europe in 1999 – Part I*, 56 BUS. LAW. 653, 685 (2001) (noting that “[w]hile International-style Offerings are not subject to the formal disclosure standards of the United Kingdom or other member states in which institutional investors may be located, the quality of disclosure documents that accompany these offerings and the due diligence work that underlies this documentation are, according to numerous of our interviewees, of a much higher quality than the formal disclosure requirements of most, if not all, European countries.”).

¹⁰¹ See Stephen J. Choi, *Assessing Regulatory Responses to Securities Market Globalization*, 2 THEORETICAL INQUIRIES L. 613, 628 n. 56 (2001) (noting that Westlaw search through SEC administrative materials for any mention of labor welfare or protection of labor found no documents).

¹⁰² For a public choice critique of the SEC, see Jonathan Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994).

firm-specific information may implement more welfare-enhancing selective disclosure policies even without regard to third party effects given the limitations of regulation.

Significantly, to the extent firms may react to the prohibition against selective disclosure through silence, Regulation FD may actually result in a decrease in share price accuracy. By removing the intermediate option of disclosing selectively to the market, regulators force firms to make the stark choice between disclosing to all or none. Firms that ignore the benefit of disclosure to third parties may very well choose to make disclosures to none under the Regulation FD regime, thereby harming third parties just as much as investors for the non-disclosing firms.¹⁰³

III. SELECTIVE DISCLOSURES AND OPPORTUNISTIC MANAGERS

Not all managers seek solely to maximize firm value. Managers may suffer from a well-recognized malady — opportunism.¹⁰⁴ Once ownership is separated from control, managers will have an incentive to divert corporate value from shareholders toward themselves. Selective disclosures provide one means for managers indirectly to divert private benefits of control. Section A discusses the possible harm to investors from managerial “bribes” to analysts and large block shareholders. Section B then examines the solution presented through Regulation FD.

¹⁰³ Merritt Fox notes that an adverse selection problem may exist with selective disclosures. See Fox, *supra* note 21, at 675-76. Fox considers a firm that determines that selective disclosures on net reduce firm value. Nevertheless, the firm is unable to commit not to engage in such disclosures (and the market lacks the ability to monitor for selective disclosures). According to Fox, “[t]he market thus discounts the issuer’s stock assuming a higher level of selective disclosure. In this situation, the firm will increase share value by engaging in the higher level of selective disclosure that the market assumes will take place.” *Id.* Two responses are possible, nevertheless, to the possibility of adverse selection. First, as this Article discusses *infra* Part IV.C, regulators may institute a reporting requirement for instances of selective disclosures to allow the market to track the selective disclosure history of a firm at low-cost. Second, to the extent the present Regulation FD ban on selective disclosures provides a credible commitment for a firm, nothing prevents regulators from offering Regulation FD as a one-way election (e.g., firms that elect into Regulation FD are thereafter governed under the provision).

¹⁰⁴ Publicly-held corporations where shareholders are dispersed may suffer from an agency cost problem. To the extent managers own only a fraction of the equity, they do not capture the full benefit from actions that increase overall shareholder welfare. Therefore, managers may seek to divert value from the shareholders and to their own individual use; in the alternative, managers may simply slack and not maximize shareholder welfare. See, e.g., Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 288-89 (1980); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-10 (1976).

A. Managerial Opportunism

Managers may make selective disclosures to enhance their ability to expropriate private benefits of control from their firm, to the detriment of the firm's shareholders. General legal prohibitions against managerial self-dealing and insider trading already exist.¹⁰⁵ Nevertheless, prohibitions against private benefits of control have their limits. Insider trading prohibitions block only some of the ways managers may benefit at the expense of shareholders. Managers, for example, may attempt to divert private benefits of control through direct salary payments and the appropriation of corporate opportunities.¹⁰⁶ The business judgment rule, moreover, gives managers great leeway to divert corporate value in spite of fiduciary duties.¹⁰⁷

In addition to legal prohibitions against managerial opportunism, market-based deterrents exist, including the possibility of a hostile takeover.¹⁰⁸ Where managers expropriate private benefits of control, an outside investor may assemble a block of shares large enough to obtain control and oust management. Short of a hostile takeover, managers also face possible discipline through the shareholder exit option — shareholders may simply sell their shares. As shareholders sell their shares, the market price may react to the sales as a signal of managerial opportunism and reduce the share price accordingly. Managers then suffer directly to the extent they are compensated through stock options. A reduced share price also increases the likelihood of an eventual hostile takeover.

¹⁰⁵ Goshen and Parchomovsky also view the opportunistic use of selective disclosures as a subset of the general problem of managerial opportunism. See Goshen and Parchomovsky, *supra* note 55.

¹⁰⁶ For a discussion of fiduciary duty limits to the ability of managers to take corporate opportunities, see Eric Talley, *Turning Servile Opportunities into Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 YALE L. J. 277, 286-310 (1998)

¹⁰⁷ For a statement of the business judgment rule, see *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (stating business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption."). See also 3A WILLIAM MEADE FLETCHER ET AL., *CYCLOPEDIA OF THE LAW OF PRIVATE CORP.* § 1036 (perm. ed., rev. vol. 1994) (describing application of business judgment rule).

¹⁰⁸ See, e.g., Frank H. Easterbrook and Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 704-05 (1982) ("Corporate control transactions can reduce agency costs if better managers obtain control of the firm's assets or if they alter the incentive structure facing existing managers. Corporate takeovers, and subsequent changes in management, increase the wealth of investors.").

Selective disclosures may then work to enhance the ability of managers to expropriate private benefits.¹⁰⁹ Managers may use selective disclosures to influence their relationship with analysts and pre-existing block shareholders.¹¹⁰ Consider the role of a pre-existing, non-control block of shares in determining the power of a potential hostile takeover to deter managers from appropriating private benefits of control. Managers of any particular corporation may face a choice in the level of private benefits that they choose to expropriate. Significantly, the size of the benefits managers expropriate may affect the incentive of outside investors to attempt a takeover. For example, managers that commit to take no private benefits of control and instead operate the company at high efficiency to maximize share value face a low risk of a hostile takeover.¹¹¹ At the other extreme, managers that expropriate large amounts of value face a correspondingly higher risk of a takeover.

The precise amount that managers may expropriate before triggering a takeover, in turn, depends on the cost to an outside investor of assembling a control block of shares. Where assembling a control block is costless, for example, managers will have only a limited ability to extract private benefits of control. To the extent managers expropriate even a small amount of value, an outside investor may improve on share value through the purchase of all shares and replacement of the managers.¹¹²

¹⁰⁹ State corporate law bars many other avenues managers may otherwise exploit to favor block shareholders. For example, managers may not make a non pro rata dividend to shareholders of the same class. See DEL. CODE ANN. tit. 8, § 170 (1998); REVISED MODEL BUS. CORP. ACT § 6.40 (1985); 11 WILLIAM MEADE FLETCHER ET AL., *CYCLOPEDIA OF THE LAW OF PRIVATE CORP.* § 5352 (perm. ed., rev. vol. 1995); EDWARD P. WELCH & ANDREW J. TUREZYN, *FOLK ON DELAWARE CORPORATION LAW: FUNDAMENTALS* § 170.2, at 340-41 (Little Brown ed. 1993); see also Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 921 (1999) ("It would be clearly illegal — and easily challenged — if the majority shareholder paid itself \$1 per share in dividends, while only paying minority shareholders \$.10 per share.")

¹¹⁰ Opportunistic managers may use selective disclosures to co-opt analysts into giving greater-than-warranted recommendations with respect to the firm's securities. Managers, likewise, may obtain the cooperation of analysts in recommending that management receive the analyst's clients support despite poor performance.

¹¹¹ Managers possess a number of devices to commit to a lower level of private benefits of control. For example, managers may implement a classified board and then install pro-shareholder directors onto the board. Alternatively, managers may increase the leverage of the firm to remove any free cash flow away from the firm, reducing the ability of managers to expropriate the cash for their own private purposes.

¹¹² For example, consider a firm whose true fundamental value without any managerial appropriation of value is \$100 per share. Suppose managers then expropriate private benefits sufficient to reduce the share price to \$99 per share. To the extent assembling a control block is costless and an outside investor is able to buy the shares at \$99 per share,

Nonetheless, assembling a block of shares is both costly and typically the cost increases with the size of the block.¹¹³ Pre-existing blocks of shares, as a result, play a large role in determining the effectiveness of a potential takeover. In the situation where the non-control block is not aligned with management, the non-control block increases the takeover risk facing managers. Shareholders that already own a toehold ownership stake need to purchase fewer shares to assemble an entire control block. Alternatively, an outside investor seeking to obtain control may purchase the non-control block, giving the investor a large first step in assembling a full control block. The existence of a non-aligned, non-control toehold block of shares then leaves managers with a reduced ability to expropriate private benefits of control without triggering a takeover.

Managers may therefore increase their ability to expropriate private benefits of control through collusion with a non-control block shareholder.¹¹⁴ An outside investor interested in obtaining control faces a higher cost to do so where significant non-control blocks of shares are present in the market aligned with the interests of management. At the very least, the presence of a management-aligned block ensures that outside investors must assemble a block larger than the management-aligned block. Even where the outside investor does assemble a larger block of shares, the presence of a hostile smaller block may hinder the ability of the larger block to control the company. To the extent the control block comprises less than 50% of the outstanding shares, for example, the non-control block may attempt to coordinate with other shareholders to elect directors. Where an upward supply curve for shares exists in the market, co-opting pre-existing blocks of shares also forces a potential acquirer to assemble a control block from more dispersed shareholders that may require a larger premium to sell their shares.¹¹⁵ Managers that co-opt a pre-existing block of shares will then have a greater ability to expropriate value from the company's

the outside investor will do so, realizing a gain of \$1 per share as it eliminates managerial appropriation of private benefits. Of course, the new controlling shareholder will face the additional cost of locating new management and therefore may require a greater gain per share before moving forward with a takeover.

¹¹³ See *supra* text accompanying notes 61-64.

¹¹⁴ Even where managers make selective disclosures to market intermediaries rather than to shareholders, they may still do so out of an opportunistic motive. A broker, for example, may "repay" management through advice to its clientele in turn to support management. Alternatively, the broker may issue more positive than warranted recommendations for the company's stock.

¹¹⁵ See *supra* text accompanying notes 63-64.

shareholders.¹¹⁶

Analysts, as well, are not free from the possibility of corruption at the hands of managers providing selective disclosures. Over a series of repeat interactions, managers may let analysts know that the flow of selective disclosures is dependent on the analysts' support of managers. Managers may also influence analysts to provide better than warranted recommendations of the company's stock.¹¹⁷ Managers that hold large, undiversified equity interests in their own corporation, in particular, will have strong incentives to bribe analysts even where outside, more diversified shareholders may not gain from such selective disclosures.¹¹⁸ Managers may also adjust the timing of firm disclosures (delaying the disclosure of significant new information) as well as the selection of firm projects to enhance the value of selectively disclosed information.¹¹⁹

Present insider trading doctrine, nevertheless, may step in to limit the ability of managers to engage in the opportunistic use of selective disclosures.¹²⁰ In *Dirks v. SEC*,¹²¹ the United States Supreme Court set forth the extent to which the insider trading doctrine may reach selective disclosure of information from corporate insiders to outside "tippees".¹²² Under tipper-tippee doctrine, selective disclosures potentially violate insider trading laws where insiders provide a tip that violates their fiduciary duty toward shareholders and the tippee knows of this

¹¹⁶ For example, managers with the support of a block shareholder with 30% of the outstanding stock will have a greater ability to expropriate private benefits of control. Any outside investor seeking to displace the managers must purchase a block greater than 30%. An upward sloping supply curve for shares makes the purchase of such a block more costly than the situation where no pre-existing block shareholder is in the market. Managers, of course, may then need to share some of their private benefits of control with the supporting block shareholder.

¹¹⁷ Managers, for example, may wish to boost artificially the firm's share price ahead of engaging in insider trading. Alternatively, a higher share price may reduce the risk of a takeover.

¹¹⁸ See *supra* text accompanying notes 78-84.

¹¹⁹ See SEC Proposing Release, *supra* note 78, at *4. Cf. Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 149 (1982) (arguing that insiders may structure corporation's transactions to profit from insider trading); Kenneth Scott, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy*, 9 J. LEGAL STUD. 801, 810-11 (1980); Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1051-64 (1982). But see James D. Cox, *Insider Trading and Contracting: A Critical Response to the 'Chicago School'*, 1986 DUKE L.J. 628, 635-36 (1986) (noting that little empirical evidence exists demonstrating existence of abusive practices designed to increase value of insider trading).

¹²⁰ But see Paul P. Brountas Jr., Note, *Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts*, 92 COLUM. L. REV. 1517, 1529 (1992) (arguing that selective disclosures from issuer to analyst as protected from insider trading liability).

¹²¹ *Dirks v. SEC*, 463 U.S. 646 (1983).

¹²² See *id.* at 665-67.

violation or should have knowledge of this violation.¹²³ In addition, the Supreme Court in *Dirks* required that a fiduciary duty breach results in a personal benefit for the insider.¹²⁴ Where the tippee trades securities based on selective disclosures under such circumstances, the trades violate Rule 10b-5.¹²⁵

Despite the theoretical reach of insider trading doctrine to opportunistic use of selective disclosures to analysts and large block shareholders, regulators face greater enforcement difficulties than with classical insider trading liability.¹²⁶ In particular, the opportunism on the part of management in a repeat relationship with an analyst or a block shareholder is often difficult to ascertain. Such opportunism is not necessarily related to the tippee's securities transactions. Management need not get anything back from the favored party except for the party's tacit support.¹²⁷ Unlike in classical insider trading, moreover, the amount of value that managers may expropriate is not related in any way to the block shareholder's trades (or trades based on the analyst's recommendations). Instead, managers gain through their ability to engage more easily in self-dealing, for example by paying themselves a higher salary.¹²⁸

¹²³ See *id.*; see also Broutas, *supra* note 120, at 1517.

¹²⁴ See *Dirks*, 463 U.S. at 662.

¹²⁵ See WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* § 5.2.3.3(b) (1996 & Supp. 2002).

¹²⁶ Cf. Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1623 (1999) (noting that "[e]arly in [his] career [he] estimated that fewer than one in five cases of insider trading is successfully prosecuted, and in retrospect that estimate is probably too high by several orders of magnitude"). Bainbridge writes:

Informants, computer monitoring of stock transactions, and reporting of unusual activity by self-regulatory organizations and/or market professionals are the usual ways in which insider trading cases come to light. As a practical matter, these techniques are available only to public law enforcement agencies. In particular, they are most readily available to the SEC. *Id.* at 1624.

¹²⁷ For example, the block shareholder may tacitly agree to support management in subsequent proxy fights or control contests. The block shareholder, moreover, may seek to develop a pro-management reputation to make such a tacit promise credible.

¹²⁸ On the other hand, the SEC in the past has taken an expansive view on how to apply *Dirks* to cases of selective disclosures to analysts. The SEC, in *SEC v. Stevens*, argued that a CEO's unsolicited calls to analysts met the personal gain test for a fiduciary duty violation under *Dirks* because the CEO did so "in order to protect and enhance his reputation." *SEC v. Phillip J. Stevens*, Litigation Release No. 12813, 1991 SEC LEXIS 451, at *2 (Mar. 19, 1991). Commentators, nevertheless, have criticized the SEC's position in *SEC v. Stevens* as inconsistent with *Dirks*. See John C. Coffee, Jr., *Is Selective Disclosure Now Lawful?*, N.Y.L.J., Jul. 31, 1997 at 5.

Significantly, the repeat relationship between management and favored analysts and block shareholders requires no formal contract to maintain it over time. All that is required is that the favored party realizes that its continued access to selective disclosure information depends on pleasing management.¹²⁹ Analysts or block shareholders may then hesitate to investigate management or release non-favorable information about management when they enjoy a flow of selective disclosure information. Regulation FD therefore may act as a preventive device to protect against possible opportunistic uses of selective disclosures where determination of whether managers are acting opportunistically is difficult. The next section assesses the effectiveness of Regulation FD in deterring the opportunistic uses of selective disclosures.¹³⁰

B. Inadequacy of the Regulation FD Response

Regulation FD encompasses a wide variety of selective disclosures.¹³¹ Despite the breadth of Regulation FD's reach, it is unclear whether Regulation FD fully blocks the ability of managers to favor analysts or block shareholders opportunistically as a means to expropriate greater levels of private benefits of control. Through confidentiality agreements as well as selective disclosures on when *not* to trade, managers may still favor particular market participants despite Regulation FD.

Regulation FD focuses only on domestic Exchange Act reporting companies and those communicating on behalf of such companies.¹³² Regulation FD therefore excludes from its reach all foreign issuers, including some of the world's largest corporations.¹³³ To the extent U.S.

¹²⁹ See SEC Promulgating Release, *supra* note 9, at *2 ("We are concerned, in this regard, with reports that analysts who publish negative views of an issuer are sometimes excluded by that issuer from calls and meetings to which other analysts are invited.").

¹³⁰ The analysis assumes implicitly that deterring the opportunistic use of selective disclosures to favor shareholders selectively to entrench managers is a worthwhile goal for regulation. Nevertheless, in a separate article with Eric Talley, I put forth the argument that allowing opportunistic selective payments to shareholders may actually increase overall corporate welfare from an ex ante perspective. See Stephen J. Choi & Eric L. Talley, *Playing Favorites With Shareholders* (Working Paper, 2001) (on file with author).

¹³¹ See *supra* text accompanying notes 9-27 (describing Regulation FD).

¹³² See 17 C.F.R. § 243.101(b) (2001) (defining issuer to encompass primarily Exchange Act reporting issuers).

¹³³ Fox notes that "over 850 foreign issuers [are] listed on the New York Stock Exchange (NYSE), the American Stock Exchange or NASDAQ, a group that includes firms with some of the largest capitalization in the world, such as Nortel Networks and Nokia." Fox, *supra* note 21, at 655. Nevertheless, Fox argues that where investors are rational and discount for the investment risks they face, no basis exists to extend Regulation FD to foreign issuers. Instead, Fox details efficiency based arguments that the foreign issuer's home country

investors own shares in the foreign issuer, managerial opportunism through selective disclosures to analysts or block shareholders remains a largely unfettered risk.

Even for domestic companies, only certain recipients are included within the reach of Regulation FD, including broker-dealers, investment advisors, investment companies, and investors where it is reasonably expected that the investors will trade on the information.¹³⁴ For example, disclosures on the part of the CEO to a mutual fund registered as an investment company would certainly fall under the initial reach of Regulation FD.¹³⁵ Nevertheless, opportunities exist for certain market participants to benefit from selective disclosures despite the prohibitions of Regulation FD.

First, a block shareholder may not qualify as an investment company, investment advisor, or broker-dealer. Instead, the block shareholder would face Regulation FD's restrictions only to the extent reasonably foreseeable that the block shareholder will engage in trades in the disclosing company's shares.¹³⁶ A large block shareholder then may sign an agreement not to trade in the disclosing company's securities for a period of time sufficient to ensure that the selectively disclosed information enters the public domain.

Even analysts and investment companies may sign a confidentiality agreement with the disclosing company agreeing to keep the information confidential and not to trade in the disclosing company's securities based on the information. Arguably, pursuant to such an agreement,¹³⁷ an analyst or investment company may gain through

should determine the issuer's selective disclosure policy. *See id*; *see also* Fox, *supra* note 98 *passim* (describing Fox's issuer nationality proposal).

¹³⁴ *See* 17 C.F.R. § 243.100(b)(1) (delineating outside investors to whom selective disclosures are limited under Regulation FD).

¹³⁵ *See* 17 C.F.R. § 243.100(b)(1)(iii).

¹³⁶ *See* 17 C.F.R. § 243.100(b)(1)(iv) (including person "[w]ho is a holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information" within reach of Regulation FD's prohibitions). *See also* Phyllis Plitch, *Companies' Widening Use of 'Gag' Option In Fair-Disclosure Rule Draws Criticism*, WALL ST. J., May 2, 2001, at C10 (reporting that companies have attempted to avoid Regulation FD's public dissemination rule through use of 24-hour confidentiality agreements with analysts).

¹³⁷ Rule 100(b)(2)(ii) of Regulation FD excludes persons that "expressly agree to maintain the disclosed information in confidence" from the reach of Regulation FD's prohibitions. 17 C.F.R. § 243.100(b)(2)(ii) (2001). Nevertheless, an open issue exists whether a recipient of selective disclosure that uses the information to engage in trades in companies other than the disclosing company violates this confidence. The SEC's promulgating release indicates that use of information under such circumstances is judged under the misappropriation doctrine. *See* SEC Promulgating Release, *supra* note 9, at *8. Under the misappropriation doctrine, the disclosing company may give its acquiescence to

trades in the securities of other related companies. Consider the instance where Kernel reveals firm-specific information selectively to Graham Investments that has signed an agreement to keep Kernel's information confidential and not to trade Kernel's securities based on such information. Graham may nevertheless employ the information in its assessment of other companies that compete with Kernel, that provide products complementary with Kernel's products, or that act as suppliers to Kernel.¹³⁸ Graham may even use the information in its overall assessment of the economy and thus gain insight on the general direction of the entire stock market. To the extent Graham is able to glean information from several different companies such as Kernel, it may have a better ability to pull together a composite view of the direction of the market compared with investors that fail to get such selective disclosures.

Second, Regulation FD allows managers to provide outside block shareholders the ability to benefit from *not* trading in securities. The ability to refrain from trading based on information is valuable. An investor, for example, may intend to engage in a sale transaction, thereby disposing of part of its holdings in a particular company. Learning that the market undervalues the securities may lead the investor to forego the sale, retaining the undervalued securities for their financial benefit.

In the context of insider trading, Jesse Fried has made the argument that insiders do not benefit from the ability to refrain from engaging in securities trades.¹³⁹ Consider the hypothetical of Jane, an insider in Kernel Inc. Assume that Jane plans to sell 10,000 shares of Kernel common stock. Suppose that Jane learns non-public material information on Kernel's valuation; the information may either indicate that Kernel is over or undervalued. Where Kernel is overvalued, Jane benefits from the sale of 10,000 shares. However, learning of the overvaluation puts Jane in the position of being an insider with a non-public material information advantage over the market. Jane thus is unable to trade where she learns that the market overvalues the security. In contrast, where Kernel is undervalued, if Jane is unable to *refrain* from

such trades in other companies, obviating the possibility of a fiduciary duty breach and thus a misappropriation insider trading violation. For a description of the misappropriation theory, see Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153 (1998).

¹³⁸ See Ian Ayres & Joseph Bankman, *Substitute Insider Trading* (Working Paper, 2001) (on file with author).

¹³⁹ See Jesse Fried, *Using Inside Information To Abstain From Trading* (Working Paper, 2001) (on file with author). For a discussion of the legality of abstaining from trading based on material non-public information, see WANG & STEINBERG, *supra* note 125, at § 4.5A.

trading, she will sell her securities for less than their fundamental value to her disadvantage.

Now compare Jane against Howard, an outside investor in Kernel. Howard also plans to sell 10,000 shares of Kernel common stock. Without an information advantage, Howard will sell both into a market that over and undervalues Kernel's securities. Like Jane, Howard loses when the market undervalues Kernel. However, unlike Jane, Howard benefits when the market overvalues Kernel. The ability to refrain from trading is therefore valuable to Jane; however, the ability to refrain from trading only puts Jane in a similar position with outside investors. Without the ability to refrain from trading, Jane is affirmatively worse than outside investors such as Howard.

Fried's argument with respect to insiders, however, depends on the inability of insiders to engage in trades once they hold non-public material information that such trades are valuable. Compared with uninformed investors, insiders have *less* ability to trade in favorable situations. The ability to refrain from trading in situations where trades are not worthwhile can be seen as a corollary benefit to insiders to balance their loss relative to outside uninformed investors.

Where insiders are in fact able to engage in trades even where they hold non-public material information that the trades are valuable, however, Fried's argument loses its force. Consider Jane again and suppose that Jane engages in a regular stock sale program, selling 1,000 shares of Kernel every month for liquidity reasons. In such a situation, at least some courts have held that insiders such as Jane may continue to engage in sales even when her non-public material information indicates that the market overvalues the securities.¹⁴⁰ On the other hand, where the market undervalues the securities, Jane may benefit from not engaging in sales. Of course, once Jane actively refrains from trades, her sell program loses its regularity. Thus, Jane loses the ability to argue that sales in situations where the market overvalues the securities are due not to inside information but rather are part of a regular liquidity sell program. Nevertheless, Jane still enjoys the one-time ability to terminate

¹⁴⁰ For a review of court cases with respect to insider trading where non-public material information is not a causal factor in the trade, see Allan Horwich, *Possession Versus Use: Is there a Causation Element in the Prohibition On Insider Trading?*, 52 BUS. LAW. 1235, 1245-1254 (1997). See also Karen Schoen, *Insider Trading: The "Possession Versus Use" Debate*, 148 U. PA. L. REV. 239 (2000) (arguing that "knowing possession" of non-public material information rather than actual use of such information should be standard for insider trading).

In addition, Exchange Act Rule 10b-5-1 provides that "a person's purchase or sale is not 'on the basis of' material non-public information if the person making the purchase or sale demonstrates that...[b]efore becoming aware of the information, the person had...[a]dopted a written plan for trading securities." 17C.F.R. § 240.10b-5-1 (c) (2001).

her stock sale program. Jane may even be able to restart her stock sale program after a suitable period of time passes, and Jane no longer has a non-public material information advantage over the market.¹⁴¹

Non-control block shareholders obtaining information through selective disclosure enjoy an even easier time to benefit systematically from the ability to refrain from trading than insiders. Where insiders and outside block shareholders are in active collusion to benefit from the ability to refrain from trading, for example, the following scheme is possible. Outside block shareholders may simply indicate to management their future trading intentions. Management may then remain silent, making no selective disclosure in situations where the trade is wealth increasing for the block shareholder.¹⁴² Without an information advantage derived from selective disclosures, outside block shareholders may then continue with their planned trades to their benefit. In situations where the trade is not wealth increasing, management may make a selective disclosure, obtaining the block shareholder's promise *not* to trade as required under Regulation FD. Block shareholders therefore gain from the ability to avoid wealth-decreasing trading opportunities.

Even in situations where managers seek to engage in the opportunistic use of selective disclosures, Regulation FD fails to block all forms of opportunism. Analysts and block shareholders in collusion with managers may still benefit from trades in other, related companies and through the ability to refrain from trading based on information obtained through selective disclosures. The next Part discusses more targeted reform alternatives that take into account the possibility of managerial opportunism in the use of selective disclosures.

¹⁴¹ In addition, insiders that disclose their general willingness to engage in insider trading ahead of time to the market may have a greater ability to profit from such trades without running afoul of the insider trading prohibitions. See Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1506-22 (1999) (noting possibility that "[b]y making a one-time, blanket statement of intent to trade, [an insider] can avoid the burden of disclosing her intention to trade on material, non-public information each time she trades company shares."). On the other hand, it is doubtful that courts would accept a one-time blanket statement of an intent to trade as equivalent to the disclosure of the actual material non-public information upon which insiders seek to trade. In contrast, Jesse Fried advocates a system of pre-trading disclosure before each instance of insider trading. See Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303 (1998).

¹⁴² On the other hand, courts may come to view silence as the equivalent of an affirmative selective disclosure when firms have a pattern of commenting only when a trade is favorable to an outside investor but remaining silent otherwise.

IV. REFORM PROPOSALS AGAINST OPPORTUNISM

This Article earlier set forth the argument for allowing firms to determine their own selective disclosure policies where the risk of managerial opportunism is low.¹⁴³ Managers, however, may use selective disclosures indirectly to engage in self-dealing. Regulation FD may then find some justification as a device to reduce the opportunistic use of selective disclosures to benefit managers. This Article argues, nonetheless, that Regulation FD acts only as an untailored response to the problem of managerial opportunism.

Rather than ban all selective disclosures, regulators may therefore wish to focus directly on opportunism. Selective disclosures, nevertheless, may differ from other forms of managerial opportunism along two dimensions. First, through selective disclosures to co-opted analysts and large block shareholders,¹⁴⁴ managers may gain greater flexibility to engage in all other forms of self-dealing. With large block shareholders co-opted into supporting the incumbent managers, for example, hostile takeovers become more difficult.¹⁴⁵ Controlling the opportunistic use of selective disclosure may therefore represent an important area of regulatory concern. Second, to the extent selective disclosures often serve to enhance overall investor value, regulators may wish to exercise caution in their approach to selective disclosures. This Article proposes several possible alternative reforms designed to separate out the beneficial uses of selective disclosure from the more opportunistic uses and thereby increase investor welfare.

A. *One-Way Ratchet Rule*

Regulators may reduce the ability of managers to use selective disclosures as a means to enhance the managers' private benefits of control through a one-way ratchet rule. Under such a rule, firms may initiate selective disclosures to specific market participants. However, once initiated, regulators may limit the ability of a firm to cut off access

¹⁴³ See *supra* Part II.

¹⁴⁴ Other mechanisms exist for managers to favor large block shareholders and analysts. Management for instance may appoint a representative of the large block shareholder to the firm's board of directors. Through board membership, the representative may then learn inside information on the firm without selective disclosure. Similarly, managers may hire a representative of the large block, paying the representative a generous salary. The manager may also enter into a contractual relationship with the large block shareholder, purchasing services at an above market rate. Managers may also offer a private placement of securities to the block shareholder at a steep discount from the prevailing secondary market price.

¹⁴⁵ See *supra* text accompanying notes 113-116.

to selective disclosures for information that it gives to other market participants. Regulators, for example, may simply prohibit the termination of selective disclosures — to the extent given to others — to a particular market participant once a firm initiates such disclosures to the market participant. This then would give the particular market participant “most favored nations” status with respect to selective disclosures.¹⁴⁶ From this perspective, Regulation FD already provides most favored nations status for all shareholders in the market. The one-way ratchet rule simply allows for differing subsets of most favored nations market participants. Through a smaller subset, for example, a firm may disseminate information indirectly to the public marketplace without sacrificing confidentiality or exposing the firm and its managers to nuisance litigation.

Significantly, a one-way ratchet rule provides firms with the ability to engage in selective disclosures to increase the accuracy of the market price. In addition, management may use selective disclosures to favor particular analysts and block shareholders as compensation for services provided to all shareholders. Whether motivated out of opportunism or simply to increase share price, managers under the one-way ratchet rule have less ability to exploit the threat of removing a particular market participant from receiving selective disclosures as a device to gain the cooperation of the participant.

On the other hand, the one-way ratchet rule does not completely eliminate the ability of managers to engage in opportunism through selective disclosures. Firms, for example, may make entry into the selective disclosure one-way ratchet system for a particular market participant conditional on that participant’s one-time support of management. Managers, alternatively, may allow only analysts with strong pro-management reputations through the one-way ratchet. Even for market participants already part of a firm’s list of required recipients of selective disclosures, managers may still threaten to cut off selective disclosures to the entire group of recipients under the one-way ratchet rule.

Regulators, nevertheless, may strengthen the one-way ratchet rule with a requirement that firms that initiate selective disclosures come under a duty to disclose selectively similar types of information in the

¹⁴⁶ “Most favored nations” type contract clauses exist in a number of commercial relationships. For an article that discusses the role of such clauses in the natural gas industry, see Keith J. Crocker & Thomas P. Lyon, *What do “Facilitating Practices” Facilitate? An Empirical Investigation of Most-Favored-Nations Clauses in Natural Gas Contracts*, 37 J. L. ECON. & ORG. 297 (1994).

future to the extent material. A firm, therefore, may choose to remain silent outside of its periodic disclosure filings with the SEC and occasional market-wide disclosures. Once a firm engages in selective disclosures of a particular kind with a specific market participant, it will then face a duty to continue doing so. Kernel, for example, may face no mandatory duty to disclose information on its contemplated new product offerings. Nevertheless, once Kernel initiates a selective disclosure of information relating to new product offerings, regulators could impose a duty to disclose similar information selectively into the future. Alternatively, regulators may require firms to specify the types of information the firm will disclose selectively to the market and hold firms accountable for the selective disclosure of such information.

Forcing disclosure of information similar to prior selectively disclosed information, however, suffers from at least two flaws. First, investors may find it difficult to enforce such a duty to disclose. For example, new entrants into the set of investors favored with selective disclosures may lack the ability to determine what types of information the firm disclosed selectively in the past.¹⁴⁷ Different “most favored nations” analysts and investors may also find it difficult to discern when a firm makes selective disclosures to other market participants.¹⁴⁸ On the other hand, in enforcing the present Regulation FD, the SEC faces similar difficulties in detecting when a selective disclosure actually occurs to the extent corporations conceal such disclosures. Second, circumstances may change and a firm may better maximize shareholder value through a reduction in the level of selective disclosures. For example, a firm may decide that confidentiality on a particular project is of such importance that even making selective disclosures relating to the project would reduce firm value. A rigid duty to continue indefinitely with similar selective disclosures may then reduce overall shareholder welfare.¹⁴⁹

¹⁴⁷ On the other hand, this Article’s proposal to require a filing with the SEC (on Form 8-K, for example) of selective disclosure events may alleviate the high cost to outside investors of tracking a firm’s selective disclosures. See *infra* Part IV.C.

¹⁴⁸ Although note that a requirement that a firm also disclose the timing and recipients of selective disclosures on Form 8-K filings with the SEC will provide all firms that enjoy “most favored nations” status to discern when a selective disclosure event has occurred.

¹⁴⁹ Regulators, nevertheless, may address this concern with a procedure to allow firms to undo the one-way ratchet for information disclosure. For example, regulators may employ an automatic sunset provision, that forces firms to disclose the same information they disclosed in the past for only a limited time, such as one year.

B. Selective Class-Based Disclosures

As an alternative to the one-way ratchet rule, regulators may allow firms to engage in selective disclosures directed toward particular classes of market participants rather than specific participants. Rather than give firms the choice to engage in selective disclosures to specific parties, regulators could force firms to establish bright-line eligibility criteria for market participants to receive selective disclosures and publicize the criteria. A firm, for example, may state that it will provide selective disclosures to all shareholders holding over a certain percentage of stock in the company. Alternatively, the firm could state that it will provide selective disclosures to all analysts that provide advice to investors holding in the aggregate above a certain cut-off amount of funds. Once the firm establishes bright-line rule criteria, regulators could then prohibit the termination of selective disclosures for the class of market participants that meet the disclosed criteria.¹⁵⁰

As with the one-way ratchet, the selective class-based disclosure system allows firms to provide selective disclosures to the market while curtailing the ability of managers to gain from such disclosures. Managers, for example, would be unable to threaten termination of selective disclosures to outside investors and analysts that meet the firm's stated selective disclosure criteria. Moreover, unlike the one-way ratchet, a selective class disclosure system does not present the potential that managers may condition initial entry into the selective disclosure system on the one-time support of the entrant for the managers' opportunistic activities. Instead, any market participant that meets a firm's criteria for selective disclosure — established at the time of the firm's initial public offering for example — would be eligible to receive disclosures.

Nevertheless, similar to the one-way ratchet rule, the selective class-based disclosure alternative suffers from the problem that a firm may still threaten to cut off disclosures to everyone in the specified class of market participants. Regulators may respond with a duty to disclose information of a similar type as disclosed in the past through selective disclosures. Such a rule, however, may prove difficult to enforce. Furthermore, as discussed above, certain firms may better enhance shareholder value with more flexibility to determine when to disclose particular information selectively.

¹⁵⁰ Regulators may also help the market track selected classes eligible for selective disclosures for specific firms through the dissemination of such information on-line. The SEC already distributes public SEC filings on-line at <http://www.sec.gov>.

C. Reporting Requirements

Rather than prohibiting selective disclosures outright, regulators may consider requiring firms to disclose information on specific selective disclosure events within a short time period following the occurrence of such events. In particular, regulators could require companies to report both the timing and the recipients of selective disclosures (on, for example, a Form 8-K filing with the SEC),¹⁵¹ although not the substantive contents of the disclosure. The timing of such disclosures should occur at a sufficient period of time after the selective disclosure event to allow the recipient the ability to benefit from trades based on such information. For companies that trade in an efficient market, for example, regulators may require disclosure relatively soon after the selective disclosure event. Because the actual content of the selective disclosure is not revealed to the market, the disclosing company may also make selective disclosures while avoiding potential strike suits based on the substance of the selective disclosures. Regulators may also eventually require companies to disclose the substantive content of past selective disclosures once such information becomes public knowledge.

The proposed reporting requirement therefore allows companies to employ selective disclosures, providing the market with indirect disclosure on confidential information. Despite retaining the continued ability to make selective disclosures, the reporting requirement lessens the ability of managers to engage in opportunistic selective disclosures. Mandatory disclosure of the timing and recipients of selective disclosures provides the market with information on the nature of the selective disclosure. For example, where the selective disclosures are made to an analyst with a strong reputation for making honest recommendations regarding the disclosing company, the market is more likely to view such disclosures as wealth enhancing. On the other hand, where the selective disclosures are given to analysts with a reputation for assisting opportunism, the market will update its valuation of the company to include the possibility of managerial opportunism. Even where the recipient lacks a definitive market reputation, market participants may still observe the actions of the recipient as well as those of management to determine the motivation behind the selective disclosure. The market price will then adjust to such new information on managerial opportunism. Where the market price drops, managers will suffer negative feedback to the extent they receive equity-based compensation. A lower market price also increases the likelihood of a

¹⁵¹ See 17 C.F.R. § 249.308 (2001) (Exchange Act Form 8-K).

hostile takeover.

Combinations of reform proposals are possible. Mandatory reporting on the timing and recipients of selective disclosures (and eventually the substance), for example, enhances the efficacy of this Article's one-way ratchet and selective class-based disclosure rules. Armed with information on a company's selective disclosure history, analysts and investors will have a low-cost means of determining whether a company is in fact providing (or denying) selective disclosures only in a manner consistent with either the one-way ratchet or selective class-based disclosure rules.

D. *The Internalization Alternative*

Rather than choose among various selective disclosure reforms that limit the opportunistic use of such disclosures while allowing shareholder-wealth-increasing uses, regulators may instead rely on the disclosing firms to select their own selective disclosure policies. At the time of a firm's initial sale of securities to the public, the firm's ownership will have strong incentives to put into place a selective disclosure policy that maximizes firm value, taking into account even the possibility of future managerial opportunism.¹⁵² Firms that put into place a shareholder wealth-reducing selective disclosure policy will receive a greater discount for their shares.¹⁵³ To increase the offering price, prior to going public, the ownership of the firm will install both optimal selective disclosure policies and mechanisms to adjust these policies in the future. Instead of blanket prohibitions against selective

¹⁵² See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305-07 (1976). On the other hand, Robert Daines and Michael Klausner report that a significant fraction, 49.9% of 300 companies conducting an initial public offering, contained classified boards and dual class voting structures among other antitakeover charter provisions. See Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protections in IPOs*, 17 J. L. ECON. & ORG. 83 (2001). Daines and Klausner are unable to find evidence in support of an efficiency related explanation for the presence of the antitakeover terms. See *id.* at 110-11.

For firms that are already public, regulators may allow firms to implement a new selective disclosure policy through a majority vote of both the board of directors and the outstanding voting shares. Many other major corporate decisions under state corporate law are conducted through such a majority vote. For example, under Delaware's General Corporation Law a majority of the voting stock of the non-surviving corporation in a merger must approve the merger. See DEL. CODE ANN. tit. 8, § 251 (2000) (requiring vote by majority of stock entitled to vote to approve statutory merger).

¹⁵³ See Lucian Ayre Bebchuk, *Limiting Contractual Freedom in Corporate Law*, 102 HARV. L. REV. 1820, 1825-27 (1989) (providing example of incentive of entrepreneurs at time of initial corporate charter to maximize value of corporation).

disclosures, therefore, regulators may wish to turn to the firms themselves to develop particularized selective disclosure policies designed to encourage shareholder wealth-increasing uses of such disclosures.

Several potential problems exist, however, with the internalization argument. First, firms may find it costly to design an appropriate selective disclosure policy from scratch once given the freedom to do so.¹⁵⁴ Regulators, nevertheless, may ameliorate such problems through the introduction of several measures aimed at facilitating the internalization of the costs and benefits of selective disclosures for firms. Regulators, for example, may make the present Regulation FD regime the default.¹⁵⁵ Firms may then vary the default based on a variety of criteria. These criteria could include: (a) the types of information allowable through a selective disclosure (e.g., some firms may opt to allow selective disclosures only for the release of earnings-related information), (b) the identities of possible recipients of selective disclosures (e.g., some firms may allow selective disclosures only to large financial analysts); and (c) the penalty for breaching the residual prohibition against selective disclosures (e.g., some firms may choose only SEC civil enforcement while others may allow for private causes of action). Alternatively, regulators may assist firms through the creation of a plausible set of menu default selective disclosure policies, including the present Regulation FD regime, the one-way ratchet rule, and selective class-based disclosure as possible options.¹⁵⁶

Regulators may also work to expand the ability of firms to define easily identifiable classes of investors to which the firms may wish to make selective disclosures. For example, a company may desire to allow selective disclosures only to outside investors with a proven track record of monitoring managers for agency costs. However, firms may find it difficult to define and track such investors through private contracts. Regulators may assist by establishing a central clearinghouse for investors to track the voting record of particular block shareholders.¹⁵⁷

¹⁵⁴ See *id.* at 1827 (noting that laws sole role in instance of initial corporate charter is “to provide background, default rules that would apply only when the parties do not specify otherwise.”).

¹⁵⁵ The default regime presented here is a subset of the overall default regime applicable to outsider trading advantages I develop together with Ian Ayres. See Ayres & Choi, *supra* note 91.

¹⁵⁶ See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 837-41 (1995) (positing that instead of providing one unitary default, corporate law may provide menu of defaults).

¹⁵⁷ Pursuant to the Williams Act, a shareholder that beneficially owns at least 5% of the outstanding stock of any class of equity to file information on its identity, background,

Firms may then use the clearinghouse track record as a means of determining to which investors managers should provide selective disclosures.

Second, investors at the time a company goes public may lack good information on whether the subsequent use of selective disclosures will increase firm value. Regulators may assist efforts in the market to value a firm's particular selective disclosure policy. Regulators, for example, may maintain a centralized database detailing a firm's selective disclosure policies.¹⁵⁸ Investors could then access any firm's selective disclosure policy and compare it against other firms in making their investment decisions. The database also could track all other means the company has chosen to use in favoring particular block shareholders.

Third, managers may lack the ability to commit to the use of selective disclosures in only a shareholder-wealth increasing manner. Regulators may therefore play a role in assisting firms to commit to a particular selective disclosure policy. Regulators, for example, may assist firms that wish to provide selective disclosures to block shareholders or analysts that meet predetermined criteria, imposing penalties on managers that fail to follow the firm's stated policy.¹⁵⁹ Such a policy may induce analysts to initiate coverage of the firm. Alternatively, the policy may induce outside shareholders to invest in constructing blocks of shares. Moreover, because the firm commits up front to such a selective disclosure policy, analysts and block shareholders are not vulnerable to threats by management to cut off such disclosures.

Fourth, firms may rationally choose to leave some degree of flexibility to adjust the selective disclosure policy with managers. To the extent the future is uncertain, the optimal selective disclosure policy may also be unknown at the time a firm initially goes public.¹⁶⁰ As a result, some

plans and purposes for the issuer if a takeover is contemplated, the source of funds, and the number of shares owned, among other information within ten days of crossing the 5% ownership threshold. See 15 U.S.C. § 78m(d) (1994) (Exchange Act Section 13(d)). One possible reform, therefore, would be to include the shareholder's voting track record in the Section 13(d) disclosure filing.

¹⁵⁸ The SEC already maintains a database of past SEC filings, under the EDGAR system, at its website (*available at* www.sec.gov). The SEC could also provide access to information on a company's chosen selective disclosure policy through its website.

¹⁵⁹ For example, a firm may adopt a special disclosure form drafted by regulators and thereby commit to making the disclosures to only specified analysts or block shareholders.

¹⁶⁰ See Bebchuk, *supra* note 153, at 1830 ("Corporations are long-living creatures functioning in an ever-changing environment. New needs, novel situations, and additional information may well make somewhat different arrangements more efficient than those initially established. Therefore, even assuming that the initial charter provided the best arrangement for the time of the charter's adoption, there would be potential for improvement as long as the charter is not what economists refer to as a complete

degree of flexibility to change the selective disclosure policy may benefit shareholders. Once given such flexibility, however, managers at some later point in time may then change the firm's selective disclosure policy to better accommodate more opportunistic uses of such disclosures.¹⁶¹ Regulators nevertheless may reduce the cost to shareholders from such midstream shifts in selective disclosure policy. At the very least, regulators may reduce the cost to investors seeking to determine a firm's policy toward future changes in selective disclosure policies. For example, regulators may keep on file a firm's stated policy toward future changes in selective disclosure policies.¹⁶² Regulators may also provide firms with a menu of options to allow future changes ranging from no changes, to changes only with a majority vote of the board of directors and the outstanding voting shares, to complete freedom on the part of managers to change unilaterally the selective disclosure policy.¹⁶³ Confining choices to a set of menu options, in turn, may allow the market to better compare and value a firm's policies toward later changes in selective disclosure policy. Of course, regulatory intervention is costly. Nevertheless, to the extent such intervention provides a benefit to companies contemplating a selective disclosure policy, regulators may recoup part of their costs through fees charged to companies that wish to access the benefits of the regulatory regime.

Through regulations designed to facilitate the internalization of the costs and benefits of selective disclosures, regulators may harness the expertise within firms on the value of selective disclosure for specific firms as well as rely on market forces to control managerial opportunism. Not all may view firms as the best-placed decision maker to determine the scope of allowable selective disclosures. Even for those that believe in some form of regulatory intervention, it is unclear however why Regulation FD represents the best solution. This Part has described a number of alternative reforms, including a one-way ratchet rule and selective class-based disclosures, that more directly address the

contingent contract.”).

¹⁶¹ See Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573 (1989) (arguing that “[o]ppportunistic amendment is possible because the corporate contract is inevitably incomplete. The parties cannot specify terms to cover even plausible contingencies.”). Gordon also argues that managers may tie a value-reducing midstream change with a value-enhancing “sweetener”. See *id.* at 1577-79. To the extent the possibility of such sweeteners is known at the time of the initial charter, however, the incorporators of the company will take into account such a possibility in selecting investor protections under portable reciprocity.

¹⁶² See *supra* note 158.

¹⁶³ Cf. Klausner, *supra* note 156, at 839-41 (1995) (discussing desirability of adopting menu defaults under state corporate law).

problems associated with selective disclosures.

CONCLUSION

Regulation FD undeniably carries with it a certain democratic populist appeal. Banning selective disclosure reduces the information advantages that certain privileged shareholders may enjoy compared with the market as a whole. No longer handicapped by as burdensome a systematic disadvantage in their trades, small investors would be more willing to put money into the capital markets and demand a reduced discount to purchase shares. This Article has argued that focusing on the ex post benefits to small investors may nevertheless harm all investors as a group from an ex ante perspective. Regulators should instead separate situations in which Regulation FD may apply to two broad categories: where managers are acting in the best interests of shareholders and where managers act opportunistically. The two categories have drastically different implications for the effectiveness of Regulation FD as a device to improve investor welfare.

In situations where managers maximize firm value, Regulation FD provides little benefit for investors. Managers may engage in selective disclosures for a variety of firm wealth-increasing reasons. Some information is confidential and the very release of the information into the broad market may reduce firm value. Other information may make a firm particularly vulnerable to a frivolous suit when released. Managers engaged in selective disclosures may therefore improve on price accuracy without suffering a reduction in firm value that a broader market release would entail. Even where a broad release of information does not by itself reduce firm value, managers may still benefit the firm and its investors through selective disclosures. Certain analysts and large block investors help monitor the firm for managerial agency problems. For example, the mere presence of a large non-control block that is not aligned with management makes a takeover more likely to the extent the non-control block holder has a lower incremental cost to assembling a control block. Selective disclosures made to such analysts and large block shareholders, in turn, may provide them the necessary incentive to initiate coverage or assemble the block of shares respectively.

Even where managers act in the firm's best interest, nonetheless, not all selective disclosures are value-maximizing from the perspective of investors. Selective disclosures work to increase the risk to uninformed investors that they will systematically receive a lower return. Shareholders that expect to receive a lower return due to selective

disclosures will in turn demand a greater discount from the firm at the time they purchase their shares. Managers acting in the firm's best interest will then have good incentives to adopt a selective disclosure policy designed to maximize the overall value of such disclosures to their shareholders. Managers, moreover, will have better information than regulators in determining when best to allow selective disclosures. The application of Regulation FD's blanket prohibition in such a situation may reduce firm value.

This Article therefore is left focusing on situations where managers act opportunistically in their selective disclosures. The opportunistic use of selective information disclosure, nevertheless, does not inexorably lead to the conclusion that Regulation FD is warranted. Indeed, where Regulation FD finds its only support as a means of limiting managerial opportunism, the SEC's ability to engage in such rulemaking compared with state lawmakers becomes suspect.¹⁶⁴ This Article argues that Regulation FD in situations where managers act opportunistically is under-inclusive. It fails to cover many substitute means available to managers to favor analysts and large block shareholders. In place of Regulation FD, several possible reforms are available. For instance, the SEC could adopt selective disclosure reforms designed to reveal the timing and recipient identity related to a selective disclosure event. Such information may help in distinguishing situations where managers favor analysts or block shareholders out of opportunistic motives and where managers act out of a desire to increase firm value. The SEC may also force firms that provide selective disclosures to do so under a one-way ratchet rule, providing most-favored nations status for recipients and thereby reducing the ability of managers to threaten the termination of such disclosures.

Regulators, nevertheless, may not need to select from among possible methods of dealing with managerial opportunism in selective disclosures. Rather, firms may internalize the effects of even opportunistic selective disclosures. In particular, at the time a firm initially goes public, entrepreneurs at the firm will have strong incentives to adopt selective disclosure policies that maximize shareholder value. These policies may therefore take into account the

¹⁶⁴ For example, the D.C. Circuit, in *Business Roundtable v. SEC*, struck down Rule 19c-4 of the Exchange Act on the grounds that the rule impermissibly affected the substantive allocation of powers among different classes of shareholders in a manner beyond the SEC's authority under Section 19 of the Exchange Act. *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) The D.C. Circuit noted that allowing the SEC to affect the allocation of powers among classes of shares would allow the SEC to affect indirectly the corporate governance of the firm and voting rights, areas traditionally left to state law. *Id.* at 414.

accuracy benefits from selective disclosures, the beneficial incentive effect on analysts and the formation of blocks of shares that monitor management, and the possibility of managerial opportunism. Thus, regulators should assist this process of internalization through the provision of menu defaults and the maintenance of a centralized database for investors to discern quickly a firm's chosen selective disclosure policy.