



# Unintended consequences of regulating disclosures: The case of Regulation Fair Disclosure

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## Abstract

The mandate that firm disclosures take a public form has recently swept through US financial markets in the form of Regulation Fair Disclosure (FD). Though the regulation was designed with a goal of leveling the playing field for investors and security analysts, this paper demonstrates it may have some unintended consequences. In particular, by forcing disclosures to be widely disseminated, Regulation FD may heighten herding among analysts and leave investors worse off. As a result of this concern, the regulation may actually inhibit the very disclosures it was intended to widen.

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**Keywords:** Disclosure; Herding; Regulation FD

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## 1. Introduction

The Securities and Exchange Commission enacted Regulation Fair Disclosure (hereafter, Regulation FD) in the fall of 2000. The regulation was aimed at curbing the practice of disclosing pertinent information to a select set of analysts and investors. Believed to be a tool for firms to influence institutional investors and curry favor with superstar analysts, selective disclosure has long been criticized as a scourge plaguing information dissemination.

Another commonly discussed, though seemingly independent, concern among the investing community is the herd behavior exhibited by security analysts (e.g., Welch, 2000). The tendency of analysts to quickly converge to a consensus also seems to undermine the extent of information available to investors. In this paper, we demonstrate that the two concerns—selective disclosure and analyst herding—may be interconnected with somewhat unexpected implications. In particular, we show that selective disclosures can have the advantage of staving off herding behavior. And, while selective disclosures limit investors' access to information initially, the postponement of herding may mean investors gain in the end.

To elaborate, we consider a model in which an investor can access the advice of firm insiders as well as two independent analysts. In the case of public firm disclosures, each analyst rationally mimics the firm's announcement (ignoring his own information), and, as a result, the investor is left with only firm information to guide her decisions.

The analysts' behavior may change when the firm selectively discloses its information. First, the analyst who is left out may be more willing to reflect his own information in his recommendation. Second, the analyst who is privy to the firm's disclosure may now be a better judge of that information given he can evaluate it using both his own private information and also the independent recommendation of the other analyst. In our setting, though the investor always follows the last analyst's advice, the delay in rubber stamping that is achieved by keeping disclosure channels limited means the investor may have more information in the end. An upshot of this effect is that a firm acting solely in the interest of the investor may choose to privately disclose if allowed. And, if faced with the requirement that disclosures be public, the same firm may withhold its disclosures all together.

Hence, in light of herding concerns, the end result of Regulation FD may be to stifle firm disclosure. Others have also raised concern that Regulation FD would suppress disclosure, but the reason typically given is fear of litigation, not herding. At the SEC's roundtable on Regulation FD, many of the participants expressed concerns over litigation surrounding judgments about the materiality of disclosures. One manager also explained that the kind of tentative information they had been able to discuss with

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