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The impact of an SEC investigation on conference call participation and analysts' forecast quality

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A B S T R A C T

We examine the impact of a Securities and Exchange Commission (SEC) investigation of Regulation Fair Disclosure (Reg FD) violations on participation during conference calls and on analysts' forecast quality. We hand-collected conference call transcript data for quarterly conference calls surrounding the date of the SEC investigation announcement over the period 2002 – 2013. We find that management's discriminatory practices are significantly higher for firms under investigation for a Reg FD violation, but management's discriminatory practices significantly decrease after a Reg FD investigation is announced. In this post-investigation period, there is greater forecast accuracy and lower forecast dispersion for firms under investigation compared to firms not being investigated. Overall, we find that when the SEC publicly discloses the existence of a Reg FD investigation, there is a decrease in management's discriminatory practices on quarterly conference calls, an increase in forecast accuracy, and a decrease in forecast dispersion. Our findings suggest that the SEC should publicly announce its investigations as soon as possible given the positive implications for the investing public, analysts, and management's discriminatory practices.

Introduction

Regulation Fair Disclosure's (Reg FD) primary objective is to level the playing field between institutional investors, analysts, and individual investors; and the academic literature suggests that Reg FD has done just that (Gintschel & Markov, 2004; Lo & Xu, 2013; Mohanram & Sunder, 2006a,b). A critical tool for the management team in their effort to remain in compliance with Reg FD is the conference call, as this tool allows for simultaneous communication with all interested parties. Nevertheless, occasionally management fails to follow Reg FD and the result is a Securities and Exchange Commission (SEC) investigation. As conference calls tend to assist management in maintaining compliance with Reg FD, one would not expect an SEC investigation to impact management's discriminatory practices in selecting conference call participants. However, our results suggest that management is more equitable in the selection of conference call participants after an SEC investigation is announced.

While financial analysts do not always receive equal treatment from management on earnings conference calls, such discriminatory practices are not explicitly prohibited. In this paper, we extend previous research on the relation between management conference call discrimination practices and analysts' forecast quality. Because management has unfettered control over which analysts are given the opportunity to ask a question on a conference call, management can engage in discriminatory practices in managing the conference call. The purpose of this study is to explore the impact of an SEC investigation on management's discriminatory practices during conference calls in relation to analysts' forecast accuracy and forecast dispersion.

Anecdotal evidence suggests that, despite laws that level the playing field for analysts to gain access to management, management continues to violate the requirements of Reg FD. An example of such a violation is the widely-publicized case of Lawrence D. Polizzotto, of First Solar Inc., who paid a $50,000 fine to settle the Reg FD charges with the SEC.[1] Thus, this study examines

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[1] https://www.investor.gov/additional-resources/news-alerts/press-releases/sec-charges-former-vice-president-investor-relations.

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firms who are officially investigated by the SEC for violating material disclosure policies set forth by Reg FD. Reg FD prohibits any disclosure of material, non-public information that is not disclosed simultaneously to the public and requires that management be intentional about reaching all financial analysts (Reg FD, 17 CFR § 243.100). Conference calls, serve as one avenue by which companies comply with Reg FD's disclosure requirements. While anyone can listen-in on these conference calls, management has complete control of who is allowed to participate on the call by asking a question. Little is known about the effect an SEC investigation has on conference call participation during these calls.

Conference calls are broadly examined in the literature and our study draws upon, and extends, the results of these prior studies. For example, Mayew (2008) finds that managers discriminate among analysts by granting increased participation to analysts with more favorable recommendations. Additionally, Mayew, Sharp, and Vankatachalam (2013) find that analysts who participate on conference calls produce more timely and accurate earnings forecasts compared to analysts that did not participate on the call. In light of these findings, we consider the impact of an SEC investigation, and by focusing on investigated firms, we examine how the announcement of an SEC investigation contributes to changes in management's practices.

With the passing of Reg FD, which became effective on October 23, 2000, the SEC enacted regulation that directly impacts selective management disclosure practices, making selective disclosures prohibited. Academic research finds that Reg FD has been effective in preventing the selective disclosure of information to analysts (Cornett, Tehranian, & Yalçın, 2007; De Jong & Apilado, 2009). However, management continues to discriminate in its dissemination of information to interested parties, most notably analysts. For example, anecdotal evidence suggests that managers are finding ways to circumvent Reg FD through the use of expert networks and social meetings with executives (Bray, 2011). Furthermore, analyst Mike Mayo's testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, as well as academic studies such as Mayew (2008) suggest that the unethical dissemination of information persists.

To conduct our analysis, we began by identifying all firms that have been investigated for a Reg FD violation over the period 2002 – 2013. We identified 28 investigated firms and then added a matched sample of 28[2] additional firms which did not undergo an investigation for a Reg FD violation, bringing our total sample to 56 firms. Our hand-collected data system included collecting data from the six quarterly conference calls immediately prior to the date of the investigation report (pre-Reg FD investigation period) and the six quarterly conference calls immediately following the report date (post-Reg FD investigation period). Thus, in total, we hand-collected and analyzed 565 conference call transcripts from the Thomson-Reuters Street Events database. We were able to match each company and the data from their conference calls with data from the Institutional Broker Estimation System (I/B/E/S), Compustat annual database, CRSP monthly stock return database, and Thomson-Reuters Institutional Holdings.

Our findings suggest that the announcement of an SEC investigation can result in positive economic outcomes for external stakeholders who rely on conference call information and analysts' forecast quality. We use hand-collected data on a comprehensive set of firms subject to Reg FD investigations to demonstrate that SEC investigations of Reg FD violations appear warranted and appear to be effective at eliminating information asymmetry among market participants. We provide evidence that management's discriminatory practices during conference calls are significantly higher before an SEC investigation compared to firms which are not under investigation. Additionally, we find that management's discriminatory practices significantly decrease after an SEC investigation is announced, and in this post-investigation period, there is greater forecast accuracy and a decrease in forecast dispersion for investigated firms compared to non-investigated firms.

Our findings have important implications: for regulators in conducting future investigations and as regulators attempt to address the costs and benefits of enforcing an equitable distribution of information; for managers seeking to lower information asymmetry between the firm and its stakeholders; and for analysts attempting to improve their individual earnings forecast accuracy. Our work suggests that the SEC is correctly identifying firms that are violating the spirit of Reg FD and that the SEC's enforcement actions are effective. Furthermore, our findings reinforce the importance of transparency on the part of the regulator, as we find that the public announcement of an investigation is a critical element in altering management's practices and has positive implications for external stakeholders who rely on conference call information and analysts' forecast quality.

We believe our research will broaden our understanding of the impacts of an SEC investigation, however there are still numerous avenues of future study. From psychology there is a growing body of work that is examining the ability to detect deception in text. Such techniques could be applied to conference call transcripts. As firms utilize other tools that allow for broad dissemination of information to a mass market in real time, such as webcasts and social media, the interplay between these and Reg FD need also be explored. Additionally, future research can examine whether analysts' stock recommendations become less biased and more profitable for firms after SEC investigations. We leave these topics for future study.

Literature review

Pattern of participation

While the academic evidence is clear as to the capital markets' reaction to SEC investigations (Jain, Jain, & Rezaee, 2010), the evidence varies as to the impact of Reg FD in altering management's choices, specifically the disclosure of material information to individuals with favorable opinions or prestigious positions. Analysts who were less favored by a company continue to experience cases where they did not have equal access to management, and this lack of access impaired their ability to gather value-relevant information in a timely manner (Brown, Call, Clement, & Sharp, 2015; Davis, 2004; Mayew, 2008; Mayo, 2002; Mayo, 2010). For example, analyst Mike Mayo appeared before Congress to recount his first-hand experience with the features of the conference call system being used to deny him access to management. Mayo (2002) states:

> *"Conference call systems let you manipulate the order that questions are answered. Last year, on one call, the operator said that my call was in the queue. I then hear, "No more questions." Do the more novice investors listening to the conference calls realize that the order of the questions can be manipulated?"*

Most recently, Brown et al. (2015) document survey responses and discussions with sell-side analysts to get insight on communication differences between executives and analysts since the passage of Reg FD. Feedback suggests that analysts continue to receive private information from management through direct contact such as a private telephone call, a corporate event, or an office visit. Firms that were once allowed to hold private,

[2] While Reg FD investigations are infrequent, our sample includes 2 cases in 2013; 2 cases in 2012; and 2 cases in 2011. Our sample also includes 22 cases over the period 2002 to 2010.