When SEC is challenged, CEOs notice

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In 2005, Siebel Systems, Inc., a California software company, challenged an enforcement action taken by the Security and Exchange Commission (SEC) that found the business had violated the Regulation Fair

Disclosure (Reg FD)—a regulation implemented to prevent businesses from giving key analysts and investors insider information. The Siebel case went to the federal court, marking the only court case under Reg FD, and it was eventually dismissed by the judge.

Now, new research at the University of Missouri shows the impact of that landmark decision and how future decisions involving the SEC could have a profound impact on the way chief executive officers (CEOs) and chief financial officers (CFOs) communicate with investors and analysts, including the amount of information they share in a private setting. The work was published in *Contemporary Accounting Research*.

Ultimately, Hoyoun Kyung, an assistant professor in the Trulaske College of Business, and his team of co-authors found the court's ruling sent the message to CEOs and CFOs that they could be more relaxed in their private interactions with analysts and investors and potentially share more information than they shared with the public.

That attitude prevailed among CEOs and CFOs until 2009 when the SEC filed another Reg FD violation, this time against American Commercial Lines. Eventually, the SEC settled out of court with the company, but the case was enough to reestablish the Reg FD as a law that businesses need to respect.

In his study, Kyung found that the effectiveness of the Reg FD depends on the perception of the SEC's ability to enforce the regulation.

"It doesn't matter that the regulation is there, if you can't enforce it, the market is going to take advantage," Kyung said. "In 2009, after businesses saw the SEC's resumption of Reg FD enforcement, they started behaving more cautiously in their private meetings."

Every quarter, publicly traded businesses must report their gains and losses to the public. However, the reporting process doesn't necessarily end there. Businesses also can meet privately with potential investors and analysts with the legal stipulation that they only share the same information they do with the public. The issue is CEOs and CFOs are sometimes tempted to build stronger relationships with these potential investors and analysts because they often have more resources than members of the general public to influence the success of the business. At times, that motivating factor can lead to businesses feeling the need to share exclusive insider information with the private investors and analysts.

In 2005, the SEC accused Siebel Systems of using body language to tip off private investors to an upswing in business after reporting losses and a negative outlook to the public. But after Siebel Systems challenged the punishment, the judicial system disagreed with the SEC's determination. The court then ruled that the SEC was being too aggressive for punishing the software company over body language.

Kyung, who is also an accountancy alumni faculty scholar, analyzed changes in stock market responses to analyst earnings forecasts and stock recommendations before and after the Siebel court case, comparing the information to content of analyst reports. He noticed a significant increase in the analyst output informativeness indicating increased information sharing by managers to analysts in private meetings. He then surveyed securities lawyers who were working with businesses around the time of the 2005 court case and asked them what was happening to create this change. He discovered that after the court case, CEOs and CFOs were often acting more relaxed in their body language when talking to the analysts. This sent the message that when a CFO or CEO acts either excited or deflated about the outlook of the business, they were more likely to tip off the analyst or private investor through their demeanor.

That began to change in 2009 after the SEC filed a Reg FD action against American Commercial Lines. In that case, a CFO for the company sent an email to analysts stating the company's earnings would likely be less than what was publicly forecasted a few days earlier. Ultimately, the SEC decided the company cooperated enough with its investigation to not impose a punishment.

Kyung said his research can be used to help people anticipate business and market reactions after landmark regulatory rulings.

In 2021, the SEC accused AT&T of leaking details about its smartphones to investor relations executives. AT&T challenged the decision in circuit court. The judge rejected AT&T's plea for dismissal but didn't rule in favor of the SEC either due to lack of proven intent. Ultimately, AT&T agreed to pay more than $6 million in a settlement, the biggest payout for this type of regulatory punishment ever.

"We don't know what the outcome of the AT&T v. SEC trial would've been, but it's possible that if this judge were to side with AT&T, we might see a similar impact to the 2005 decision," Kyung said. "It's likely that at some point, someone can challenge the SEC again, and this research can help people understand how businesses will respond."

More information: Ashiq Ali et al, Managers' private communications with analysts: The effect of SEC v. Siebel Systems Inc., *Contemporary Accounting Research* (2023). DOI: 10.1111/1911-3846.12858

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