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Securities and Exchange Commission
100 F St. NW
Washington, DC 20549-9303
Rule-comments@sec.gov

Re: Comments on Earnings Releases and Quarterly Reports

File S7-26-18

Dear SEC:

Here are my comments on the frequency of required disclosures.

In summary

- There are two issues: 1) Content of disclosures and 2) Frequency of disclosures.
- Disclosure is costly.
- Forced disclosure breaches intellectual property rights and should only be done when there is an overwhelming public purpose.
- Lack of disclosure is costly.

[1] All opinions are strictly my own and do not necessarily represent those of Georgetown University or anyone else.

- The optimal content and frequency of disclosure represents tradeoffs between the costs and benefits to different parties.
- Investor preference is function of investment horizon. Long-term investors prefer to pay for less frequent disclosure than short-term investors.
- SEC should engage in evidence-based rulemaking through a scientifically designed pilot experiment with both different content and different frequencies of disclosure.
- The optimal frequency of disclosure is not zero. SEC should engage in vigorous enforcement of insider trading in securities of non-registrants.

It is not clear at all that quarterly financial reporting is optimal for the U.S. capital markets. The current quarterly reporting scheme was inaugurated long ago before the internet. Investors are now able to access far more information from a variety of sources than ever before. Is quarterly reporting obsolete? Or not frequent enough? Now is a good time to re-examine this issue with fresh eyes taking into account changing technology. I commend the Commission for examining this issue.

There are two issues: 1) Content of disclosures and 2) frequency of disclosures.

Investors benefit from the timely disclosure of standard, reliable and value-relevant information. Good disclosure permits investors to properly value a firms for investment purposes and also to monitor management for corporate governance purposes.

Disclosure is mandated for good reason: Our markets run better when they do. There is a long and sad history of issuers not disclosing important information that investors needed to make good investment decisions. Human nature is such that issuers willingly reveal some information while jealously guarding other information. Mandatory disclosure of accurate value-relevant information provides the information that investors need to make good investment decisions.

The lack of disclosure increases the asymmetry of information between insiders and outsiders, leading to more suspicion of insider trading. In such cases, investor transaction costs go up and liquidity goes down.

However, it is not at all obvious what information needs to be disclosed. It is also not obvious how frequently that information needs to be disclosed. Different jurisdictions have very different requirements on both the content and frequency of mandated disclosures. In this comment letter I will address the frequency issue and leave the content issue for another time.

Mandated quarterly reporting on Form 10-Q goes back to 1970.[2] No comprehensive cost-benefit analysis was done at the time. A rule release such as 1970's SEC Release 34-9004 would certainly not survive today's standard of judicial review.

[2] SEC Release 34-9004, 35 Federal Register 17537

Mandated disclosure is costly.

We must never forget that information is the valuable intellectual property of the firm and its shareholders. Corporate boards have a fiduciary obligation to act on behalf their shareholders and thus release the right amount of information, neither too much nor too little. Companies are naturally reluctant to release information that puts them in a bad light, or that could be useful to their competitors. As one CFO quipped to me, "The only folks who really read our 10-K are our competitors."

On the other hand, they do have an incentive as well as a fiduciary obligation to reveal information that they believe is useful to their current or potential shareholders or for other business purposes.

The fact that disclosure is mandated is strong evidence that disclosure is costly. The costs start with the direct accounting, legal, and managerial costs of preparing disclosure filings. But those easy-to-measure costs are just the tip of a hard-to-measure iceberg. The cost of managerial distraction over the release is another major cost. Would that time be better spent on building the business rather than the quarterly earnings dance? Another cost is the cost of revealing information that is valuable to the competitors but not necessarily the shareholders.

The big cost is that mandated reporting deadlines create incentives for short-termism on the part of management. Under pressure to meet a very visible Wall Street forecast, management is unfortunately incentivized to take short-term actions to meet that goal but that have long-term negative impacts. These actions include:

- Cutting R&D
- Deferring needed maintenance
- Reducing advertising
- Delaying new hires
- Manipulating accounting accruals
- Channel stuffing
- Booking sales before they are actually made

Forced disclosure breaches intellectual property and financial privacy rights and should only be done when there is an overwhelming public purpose.

Information is valuable intellectual property. In recent years, jurisdictions around the world (including the United States) are appreciating more the value of intellectual property and are building stronger legal protections. These stronger protections include tougher copyright and patent laws. Similarly, jurisdictions around the world are also building stronger laws to protect financial privacy as well. Our legal system should only breach these fundamental rights to privacy and property when there is an overwhelming public purpose. Even when there is such a purpose, disclosure rules should be designed to achieve their objectives with the least possible amount of breaching of privacy and intellectual property.

Lack of disclosure is costly.

There is a strong public purpose for requiring financial disclosure. Lack of disclosure is also costly. Without accurate and timely information, markets cannot properly price a security. Even worse, the existence of not-yet-revealed information creates incentives for insider trading. This deters investors who don't want to invest when they know the insiders know more than they do. Market participants price this into their trading decisions, and investor trading costs increase.

Is 10-Q obsolete?

The world has changed substantially since Form 10-Q was mandated in 1970. Back then, it was very difficult to get current information about what was going on inside a firm or its industry. We now live in a world with much better information flows. Indeed, more frequent disclosures are already mandated on Form 8-K. Much of the value-relevant information is already released long before the quarterly release. Indeed, Ball and Shivakumar (2008) found that quarterly earnings announcements represent only about 1 to 2 percent of the information released in the market.[3] Are the costs worth the benefits?

Mandating more frequent than necessary reporting for US firms puts US firms and exchanges at a competitive disadvantage relative to their foreign competitors.

The European Union adopted quarterly reporting, but then reversed itself and went back to semi-annual reporting. Nothing bad happened. US companies globally with other companies that are not burdened by US disclosure requirements. Forcing US companies (and US exchanges) to report more often than necessary puts them at a competitive disadvantage.

The optimal content and frequency of disclosures represent a tradeoff between costs and benefits.

As disclosure is costly, it is obvious that requiring issuers to file audited 10-Ks every single day is overkill. It is similarly obvious that never releasing audited financials is a recipe for securities fraud. The optimal frequency of disclosure is somewhere between these two extremes, but where?

[3] See Ball, Ray, and Lakshmanan Shivakumar. "How much new information is there in earnings?" *Journal of Accounting Research* 46.5 (2008): 975-1016.

When information is disclosed, the market quickly absorbs the information.[4] The cost of the lack of disclosure is the drift between the actual market price and the full-information price. This causes harm to investors in two ways:

1) Expected losses caused by transacting at a price different from the full-information price.
2) Increase in transactions costs such as a higher bid-ask spread.

Let us examine these two elements of cost more closely:

When market prices do not reflect the full-information price, market prices will contain extra noise. The market price may fluctuate above or below the full-information price. This adds to the idiosyncratic risk of the stock. However, this drift away from the full-information price could go either above or below the full-information price. Investors could gain or lose because of this drift. Whether an investor gains or loses from it depends on which way the drift is and whether they are a buyer or a seller. Because this risk is based on events that are mostly unique to the firm, it is diversified away in a portfolio. This means that it is not priced in many asset pricing models such as the basic Capital Asset Pricing Model and many multifactor models.[5] Translation: small amounts of noise don't matter that much.

It is well known that increased asymmetric information increases transactions costs such as the bid-ask spread. Stoumbos (2018) has documented that the Amihud illiquidity ratio in US grows between earnings announcements.[6] When international firms switched from semi-annual to quarterly reporting, Amihud illiquidity was reduced up to 5% in second quarter. To translate this into English: transactions costs go up when there are longer reporting intervals.

<u>Short-term investors prefer more frequent disclosure than long-term investors.</u>

Long-term investors incur the cost of periodic disclosure repeatedly over their investment horizon. However, they only incur transactions costs when they buy and sell, which by definition is very infrequent for long-term investors.

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[4] Rapidly is in the eyes of the beholder. While stock prices respond almost immediately to earnings announcements, there is usually a slight post-earnings announcement drift as it takes time for the market price to incorporate all of the information.

[5] Idiosyncratic risk is priced in some models of segmented capital markets, such as Merton (1987). The impact is small, however, for large well-known companies. See Merton, Robert C. "A simple model of capital market equilibrium with incomplete information." *The Journal of Finance* 42.3 (1987): 483-510.

[6] See Stoumbos, Robert C., How Does More Frequent Reporting Reduce Information Asymmetry? (July 25, 2017). Columbia Business School Research Paper No. 17-75. Available at SSRN: https://ssrn.com/abstract=3008708 or http://dx.doi.org/10.2139/ssrn.3008708. See also Fu, Kraft and Zhang, 2012, Financial reporting frequency, information asymmetry, and the cost of equity, *Journal of Accounting and Economics* 54, 132-149.

To the long-term investor, the net present value of their investment looks like this:

Net Present Value =

- **-** Purchase price
- – Purchase transactions costs
- + Present value of expected future cash flows
- – Present value of expected future disclosure costs
- + Present value of expected final selling price
- – Present value of expected selling transactions costs

Short-term investors, on the other hand, will incur a smaller series of disclosure costs. At the extreme of short-term speculators, they will incur none:

Net Present Value =

- **-** Purchase price
- – Purchase transactions costs
- + Present value of expected final selling price
- – Present value of transactions costs

In short, the speculators care only about transactions costs, which are reduced by frequent disclosure. They don't care about disclosure costs. The long-term investors care more about disclosure costs and less about transactions costs. To the long-term investors, the transactions costs are a very small part of their total cash flow calculations. To short-term speculators, transactions costs are a huge part of their total investment calculations.

The optimal frequency of disclosure represents a compromise between the desires of short- and long-term investors.

This means there is no one frequency of disclosure that all investors will choose. The optimal frequency of disclosure represents a trade-off between the needs of these various investment clienteles. Short-term investors bring liquidity and information to the market and thus assist in price discovery. Their willingness to trade purely on price reduces transactions costs for long-term investors. Long-term investors bring a stable shareholder base that has an incentive to pay attention to corporate governance. The healthiest ecosystem for a particular stock represents a mixture of both short-term and long-term investors.

SEC should engage in evidence-based rulemaking through a scientifically designed pilot experiment with both different content and different frequencies of disclosure.

Rather than decide the issue based on gut feel or obsolete studies from a previous century, the SEC should engage in a carefully designed pilot experiment to examine the impact of different approaches to disclosure. The experimental treatments should examine both the content of disclosures and the frequency of disclosure.

The pilot should explore monthly, quarterly, semi-annual, and annual filing frequencies. Likewise, it should explore various formulations of what content to disclose, ranging from simple metrics such as only sales up to the current full-blown 10-Qs. It should examine the impact on direct accounting costs as well as on stock trading transactions costs. In addition, it should monitor the market responses to the various information releases as well as managerial responses to additional reporting flexibility.

This will provide the evidence needed to make a proper decision.

The optimal frequency of disclosure is not zero. SEC should engage in vigorous enforcement of insider trading in the securities former SEC registrants.

In response to question 46 in the release, I wish to emphasize the plight of the public shareholders of firms that have terminated their registration status.[7] In general, firms are able to terminate their registration status when they have fewer than 300 shareholders "of record." Since shares held in street name don't count as shareholders "of record," and most shares are now held at DTCC's Cede and Co., it is extremely easy for most SEC registrants to de-register if they wish.

I am a shareholder in several of these companies. Some of them do an admirable job of keeping their shareholders informed with relevant financial information. Others follow a "scorched earth" policy of shareholder suppression. They take actions to reduce the value of their remaining public shares by refusing to release any financial information. They then take advantage of the reduced public share price in order to gradually acquire the remaining shares at a significant discount to their true value. This frequently violates the spirit if not the letter of state tender offer laws.

These are classic cases of insider trading: The insiders buy up shares while the public market is uninformed. The anti-fraud provisions of our securities laws (§10 of the '34 Act and the rules thereunder) are not limited to SEC registrants. They refer to "in connection with the purchase or sale of any security" – not just NMS stocks.

The SEC should vigorously enforce these egregious cases of insider trading. They are easy to detect. Just watch what happens to the public securities of former registrants and see who is buying them. A few well publicized-speeches along with some well-publicized prosecutions will send a warning shot to those who

[7] Release questions #46 asks: "Are there additional approaches that we should consider to better facilitate the dissemination of timely periodic information to investors and other market participants?"

would mistreat minority shareholders of former registrants. In addition, the SEC should send a warning letter to each filer of a Form 15 informing them that the insider trading laws still apply and they should disclose appropriate information before engaging in transactions in their securities. This will protect investors by inducing former registrants to provide appropriate amounts of public information.

Respectfully submitted,

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