

The Limits of Corporate Disclosure

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The growing global market economy and various competing stakeholder interests have caused corporations to face increased scrutiny. Indeed, the level and desirability of transparency through disclosure acceptable to both the corporation and the growing number of stakeholders remains a difficult balance. Many have argued that the lack of transparency and accountability exacerbated financial weaknesses at the corporate and national levels in some of the more recent regional financial crises.

As a corporation seeks outside capital and more market liquidity in its stock, it must look to investors not familiar with their day-to-day operations. Therefore, the public corporation must open its books and operations to attract investment sufficient to fund its wider-ranging operations and gain investor confidence. This puts a public corporation at a disadvantage due to the added costs to produce the information and added scrutiny of its operations by the public, including competitors.

A closely held company, by contrast, controlled by a relatively small number of shareholders or family members does not face the same transparency requirements. Most closely held companies still the prevalent form of business organization interact with a small circle of investors and business associates and operates with minimal disclosure. While this form of organization is effective on a local level, it is difficult to grow beyond a certain size, being limited by the wealth of the insiders. Furthermore, access to capital markets is limited by the lack of transparency in their businesses as they compete with other domestic and international entities for scarce international funds and the attention of investors and other stakeholders.

Transparency, however, is not an end in itself. There are costs to produce high quality information. Markets will seek a compromise between the high cost of collecting, analyzing and using information and the need to disclose the information to serve the interests of the various stakeholders and for the public good.

Stakeholders in Corporate Disclosure

In both emerging and established markets, corporations are asked to be more open in reporting, not only about their financial affairs, but how they have performed against key social, ethical, and environmental dimensions. Consequently, corporations need to respond to or balance the interests of many stakeholders, including: management, the board of directors, shareholders (including institutional investors), trading partners, creditors and customers, and governments.

All of these competing interests must be considered in examining a framework on corporate disclosure and the limits of such disclosure. In order to foster confidence in the marketplace, there must be an adequate framework to ensure timely and accurate disclosure.

However, this framework is useless without safeguards to level the playing field among investors and mechanisms for appropriate enforcement.

Mandatory Disclosure

Most developed capitalist countries impose an affirmative obligation on issuers of corporate equity to disclose certain information about their operations. Mandatory disclosure ensures equal access to a minimal level of information. Most disclosure regimes are designed to protect investors and the integrity of the market. Without a high level of transparency, the investor cannot be assured that he or she received a fair execution price for a buy/sell order in the market.

While each country must develop standards that address their particular needs, some disclosure standards should be considered in a mandatory framework. Prior to an initial securities offering, an issuer should be required to provide investors with a minimum level of information mandated by statute or regulation. Once a corporation has completed the initial sale of its securities a framework of mandatory periodic disclosure designed to provide stakeholders with the ability to evaluate their investment or the advisability of undertaking such investment must be established. Stock exchanges must also impose a minimum level of disclosure for listing corporations to maintain the market's integrity. At the same time corporations should have a duty to disclose all material information not currently available to the public prior to trading the corporation's securities. Finally, if a corporation has made a statement that was inaccurate at the time it was made, the corporation should have a duty to correct such statement as soon as it discovers the information to be incorrect.

Voluntary Disclosure

While a mandatory framework provides corporations with a set of minimal requirements, corporations often will find that the stakeholders seek much more than what is mandated. Voluntary information often involves projections and other forward-looking information, which in many cases is more important than the mandatory disclosure of historical information. However, this forward looking or "soft" information can often lead to litigation and challenges as being misleading.

In the United States, legislation provides a safe harbor for forward-looking statements to encourage companies to provide prospective information about their operations without fear of litigation. These statements must meet certain criteria including being clearly identified as forward-looking statements and accompanied by cautionary language identifying important factors that could cause actual results to differ materially from those projected in the statement.

Certain individuals or entities, such as securities analysts, principal stockholders or institutional investors, may have a familiar relationship with management of the corporation and, often, because of that relationship, have access to non-public information. Often meetings with these parties are in private and foster an appearance of favorable treatment over other

stakeholders. Any disclosure regime needs to address this perceived problem of selective disclosure.

Often, however, corporations are required to disclose information to various government agencies as part of the agencies oversight or regulatory mandate. These disclosures, such as those in the financial institution area, often are important in monitoring the health of a particular industry. As long as these disclosures are kept confidential, the corporation is more candid in its assessment to regulators. For these reasons, a disclosure regime should ensure that regulatory disclosure should be confidential, unless it is necessary for the public good.

Transparency has its Limits

One of the most profound trends of the past few decades has been the demand by the public for greater disclosure of information. The global economy has accelerated due, in part, to the ability of corporations and other entities to communicate information across borders more or less instantaneously through various technologies. This added ability to communicate also has its downside, as corporations must be ever vigilant to reduce the risks of inadvertent or unwanted disclosure of information. In this new era, a corporation and its stakeholders must filter information and determine what is accurate and what is not.

While emerging market economies are generally moving towards increasing the level of disclosure required of corporations, credible limits are necessary to protect the corporation from unnecessary disclosure and disclosure that could put it at a competitive disadvantage through added costs and scrutiny.

In a true open economy, corporations would be required to disclose only material information. U.S. courts have held that information material if there is a substantial likelihood that the disclosure of an omitted fact should have been viewed by the reasonable investor as having significantly altered the total mix of information made available. For example, a fact would be material if an investor would have had considered the fact important when deciding to buy, sell, or hold the stock. Unfortunately a completely voluntary format would probably lead to inconsistent and limited disclosure by corporations.

Intellectual Property

The protection of intellectual property such as patents, trademarks, copyrights, trade secrets, and source code is also an area of concern in regards to disclosure. While there is no uniform agreement in the treatment or protection of such intellectual property, the concept is well understood internationally. Intellectual property is intrinsically intangible and unlike manufacturing, which seeks the lowest cost of production across boundaries, countries seek to limit the movement of intellectual property arguing that laws are needed to protect financial interests in creative works because such protection fosters and encourages more creativity, which, in turn, creates opportunity. There is, however, a very vocal minority of stakeholders that regard protecting ownership of intellectual property as a hindrance to the true marketplace of ideas.

In any event, a corporation will continue to seek broad protections of intellectual property rights to maintain its competitive edge. Unlike mandatory disclosure laws, intellectual property laws limit the level of disclosure or provide proprietary protection to property already public. Any framework for the protection of intellectual property must have standards to protect, and recourse for infringement including, monetary, injunctive, or criminal sanctions.

A controversial area of intellectual property law is that of trade secrets. As a general rule, a trade secret can be any information not commonly known in the relevant industry that is used in connection with a business to obtain a competitive advantage and the information is secret, is identifiable, and is not readily ascertainable. Because there is no global law of trade secrets or even a definition of what constitutes a trade secret, it is possible that something considered a protected trade secret in one country, may not have similar treatment in another. Because of this, corporations will seek to limit the disclosure of trade secrets both physically and through contracts. Additional legal protections are sought under the argument that the disclosure of such secrets provides competitors with an unfair advantage reaping the rewards of often time-consuming and costly research without compensation to the corporation that expended the resources. Effective protection of such property often can mean the difference between success and failure.

Activism

Corporations must evaluate the cost of achieving compliance with environmental laws as well including, liabilities from actual or threatened legal proceedings, the prospective and material impacts that may result from emerging trends in environmental regulations and developments. Corporations are reluctant to disclose possible environmental problems, fearing protracted and costly litigation and community unrest. However, community stakeholders will continue to seek corporate disclosure of activities that impact environmental matters such as global warming, contaminated land, toxic waste, and resource use. A framework setting standards for disclosure in this area should address the possible environmental liabilities and if conditions warrant disclosure.

Premature disclosure of corporate negotiations can also be detrimental to corporations seeking to combine through merger, acquisition or otherwise. If information leaks before a deal is signed or the major terms are decided, either side could lose their leverage in negotiations as the stock prices of the acquiror and target will react to disclosure of such information. While corporations, for the most part, should be able to negotiate in secrecy in order to enhance the chances of a favorable deal, there are certain circumstances where the corporation has a duty to disclose. For example, a corporation should be required to disclose such deals when it is trading in its own securities.

Likewise, the closing of a plant or major office or a large layoff of the workforce in a community can evoke strong emotions and at times leads to disruption. Corporations seek to maintain their businesses in an efficient manner and at times must make these decisions. There is recent legislation in some countries requiring companies to give advance notice with respect to

such actions that will effect a particular community, even if not material to the overall operations of the company. Such notice provides the affected workers or their representatives, the community, or the local government an opportunity to react and possibly forestall or stop the closing either by law or negotiations. While the interests of the stakeholders are obviously different from corporations, governments must be careful to not hinder the ability of a corporation to make sound business decisions.

Indeed, shareholder and community activism has brought to the corporate boardroom many social and ethical issues that were once the concerns of State. Disclosure is sought on matters such as human rights, labor, and fraud and corruption. These areas for the most part are voluntary and should remain such unless material.

Enforcement and Compliance

A good corporate disclosure framework will be ineffective unless there is in place a mechanism to enforce compliance and assure the market that all investors have equal access to disclosed information. When developments are on hand which are likely to have a significant effect on market activity in, or the price of, a corporation's securities, the insiders of a corporation have a responsibility to ensure that such information is kept strictly confidential until a formal announcement is made. The general principal should be disclose or refrain from trading. Civil and criminal penalties should back-up the prohibitions.

To ensure timely and accurate information, any disclosure system must provide investors with a framework to seek redress for damages for violations of such laws. A private right of action serves to level the playing field as corporations and their insiders can be held liable for inaccurate or misleading disclosures. When coupled with a strong enforcement record by the government or its agency, private rights of action serve to self-police adequate corporate disclosure.

Globalization, technology and innovation are rapidly changing the markets, organizations, and institutions. While it is difficult to determine the specifics of the form corporate disclosure will take, a few things are apparent including that reliable, accurate and timely information is a market fundamental, and that globalization is forcing convergence of standards. Technology also plays a role, transcending legal and geographic boundaries and forcing regulatory convergence.

In the information society, the days of complete corporate secrecy and opaqueness are over. Disclosure is necessary, however governments must continue examining the various stakeholders' interests and balancing these interests for disclosure with the costs to the corporation and the economy, providing an efficient and open economy.