
THE ROLE OF PUBLIC REGULATION AND THEORIES OF CORPORATE INFORMATION DISCLOSURE: A DICHOTOMOUS APPROACH TO CORPORATE INFORMATION DISCLOSURE AND INSIDER DEALING REGULATION

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ABSTRACT

This article examines the role which the theories of corporate disclosure and public regulation play in ensuring effective corporate disclosure regulation. The article makes a case for public regulation, arguing that the public nature of material information lends support to the view that neglect or failure to publish material information should be enforced through the public machinery rather than through private orderings alone. The article further contends that effective corporate information disclosure and insider dealing regulation requires both robust public enforcement and complementary private enforcement mechanisms. Through an analysis of the Capital Cost Reduction Theory, the Liquidity Enhancement Theory, and the Hydraulic Theory of Disclosure, this article demonstrates that incorporating these theories into the legal framework is likely to result in more effective regulation of corporate information disclosure and insider dealing, thereby promoting market cleanliness, transparency, and investor confidence.

Keywords: corporate disclosure, insider dealing, public regulation, securities market, market integrity, Zambia, Efficient Market Hypothesis.

1. Introduction

This article examines the role which the theories of corporate disclosure and public regulation play in ensuring effective corporate disclosure regulation. A central argument advanced herein is that the public nature of material information lends support to the view that neglect or failure to publish material information should be enforced through the public machinery as opposed to private machinery or private orderings alone.

A further basis for the case for public regulation is the absence of adequate civil remedies for non-disclosure.¹ Even though private enforcement of non-disclosure can act as a complementary means of ensuring commutative justice for failures to disclose, some issuers and investors in the securities market may neglect or fail to commence private civil recovery actions.² Therefore, a power on the part of the public regulator to commence civil recovery actions on behalf of those market players who fail or neglect to do so is likely to ensure that there is no perception of laxity in the enforcement of regulatory rules.

Where a securities Ponzi scheme causes loss to participants in a securities market,³ the cleanliness and integrity of the market may be compromised beyond the private pecuniary losses of individual participants.⁴ In such circumstances, the Securities and Exchange Commission (SEC), the Bank of Zambia, and the Pensions and Insurance Authority, as the competent regulatory authorities for the Zambian financial market, have an obligation to step in and investigate and sanction the culpable market players.

[I]n capital markets parlance, 'market integrity' seems to have acquired a meaning that ranges along a spectrum. Thus the meaning of this phrase extends from mere elimination of identified dishonest practices in the market at one end to ensuring that markets are fair for all participants at the other.⁵

Robust enforcement of disclosure requirements, as a component of the regulatory toolkit for ensuring market cleanliness, plays a vital role in safeguarding investor interests, promoting transparency, bolstering investor confidence, and upholding the integrity of the stock market as a whole. The integrity and transparency of the stock market rely on the effective implementation of criminal and civil penalties, as well as the provision of damages for investors who experience losses due to non-disclosure.⁶

Effective enforcement of the disclosure regime is likely to ensure compliance, which in turn is likely to encourage future investment. As Manne observes:⁷

"In the main, disclosure regulation is explained in three interrelated ways. First, investors will make better investment decisions (and managers will more likely act in investors' interest) when those decisions are considered in the light of otherwise undisclosed, relevant information. Second, required disclosures will cause stock prices better to reflect underlying firm value, thereby enhancing market accuracy. And third, fraud will be deterred because '[s]unlight is said to be the best of disinfectants.'"

2. The Case for Public Regulation

In modern economies, capital is allocated mainly by markets.⁸ Ideally, under certain market theories—such as the Efficient Market Hypothesis—the allocation of capital is meant to be optimal. However, the conditions necessary to achieve that optimum are frequently not present.⁹ Where resource allocation is sub-optimal, this creates the possibility that some intervention could improve conditions,¹⁰ and one such intervention is government regulation.¹¹

In the context of government intervention as a remedy for market imperfections, the Efficient Market Hypothesis postulates that a financial market is efficient—that is, informationally perfect—if the prices of listed securities fully and correctly reflect all material information available about the issuers, their securities, and their business.¹² Put differently, a financial market is efficient with respect to a given information set if security prices would be unaffected by publishing that information to all market players. This implies that efficiency with respect to a particular information set makes it impossible for market players to earn an economic profit by trading on the basis of that information set.¹³ Government intervention should therefore be directed at mandating corporate information disclosure and enforcing non-disclosure. Insider dealing thrives on non-disclosed information; by publishing all available information to investors, the opportunities for insider dealing are likely to be eliminated. Effective regulation of insider dealing deters insider trading, thereby removing the incentives for trading on the basis of unpublished price-sensitive information. Conversely, effective insider dealing regulation compels disclosure and contributes to market efficiency. There is thus a symbiotic relationship between insider dealing regulation and corporate information disclosure regulation.

In the context of efficient financial markets and efficient capital allocation, as observed in the seminal case of *United States v. O'Hagan*,¹⁴ "investors like would hesitate to venture their capital in a market where insider dealing is unchecked by the law."

Government intervention as a means of remedying market imperfections should also be directed towards achieving equal access to financial markets. One of the pillars of such access is equal access to material information. As insider trading thrives on information asymmetry, it should be regulated on grounds of fairness and equality. Thus, the United States Supreme Court in *Securities and Exchange Commission v. Texas Gulf Sulphur* stated that:¹⁵

"...to prevent inequitable and unfair practices and to ensure fairness in securities transactions generally, whether conducted face to face, over the counter, or on exchanges... the Rule [meaning Rule 10b-5] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on the impersonal exchanges have relatively equal access to material information."

Equal access to material information presupposes effective supply of material information. It follows that effective regulation of corporate information disclosure is a necessary means of ensuring such effective supply. The other forms of intervention include taxes, subsidies, and improvements to education and infrastructure.¹⁶ Against this background, public interest theory claims that government regulation can improve markets, compensate for imperfect competition, remedy unbalanced market operation, and address undesirable market outcomes.¹⁷ Public interest theory, as a part of welfare economics, emphasizes that regulation should maximize social welfare and that it should be subject to a cost-benefit analysis to determine whether increased social welfare outweighs the regulatory cost.¹⁸

3. Public Interest Regulation: Vertical or Horizontal?

Public interest regulation is a form of vertical policing, supervision, and enforcement of regulatory rules. It involves the action of a government agency or institution that polices the actions and omissions of market players—both public and private. Private interest regulation, as the name suggests, is a form of horizontal enforcement which involves the enforcement of regulatory rules by market players either as members of a particular class or as individuals.

In the context of this article, public interest regulation refers to the enforcement of disclosure and insider dealing rules by the Securities and Exchange Commission (SEC) against market players. Where necessary, the SEC, in the execution of its public interest regulatory role, supervises market players to ensure compliance with applicable market rules. As a complement to public interest regulation—that is, vertical regulation—market players injured by the misconduct of others should have the right to institute criminal prosecutions and civil recovery actions. Effective regulation, supervision, and enforcement of regulatory rules requires effective public interest regulation that is effectively complemented by private regulation. However, this article submits that public interest regulation should be preferred to private enforcement on the ground that there are presently no civil remedies for breaches of both disclosure rules and anti-insider dealing rules.¹⁹

Samamba observes that, originally, two assumptions seem to have driven the public interest theory of regulation and shaped economic policy formulation.²⁰ The first assumption was that economic markets are extremely fragile and likely to operate inefficiently or inequitably. The second assumption was that government regulatory intervention is costless. On the basis of these assumptions, it was easy to argue that government intervention in the economy was simply a response to public demand for remediable inefficiencies and inequities in the operation of the free market.

In the context of Zambia, the markets are indeed fragile—particularly because market participants who suffer pecuniary loss as a result of insider dealing have no right to compensation or damages. Consequently, these markets are fraught with risk, which is likely to discourage market participation. The first assumption therefore still holds in the Zambian context. This lends support to the public interest regulation theory. As regards the second assumption, however, it cannot hold in this cyber age, because curbing fraudulent acts such as insider dealing is expensive and requires sophisticated and costly technological equipment.

3.1 Reformulating the Public Interest Theory of Economic Regulation

Empirical evidence supporting the public interest theory of regulation is sometimes challenged on the ground that poor performance or failures of the regulatory process are not the result of any unsoundness in the basic regulatory goals, but of particular weaknesses in personnel or procedure that could be corrected at relatively low cost as society gains experience with public administration mechanisms.

3.2 Private Regulation as a Complement for Public Regulation

The role of private regulation in enhancing the efficacy of public interest regulation cannot be overstated. Corruption in the public enforcement system, incompetence, and lack of skill on the part of government agents may undermine the quality of public enforcement. Therefore, as a means of mitigating the negative impact of these shortcomings, private regulation should be promoted.²¹

In its reformulated form, the public interest theory of regulation holds that regulatory agencies are created for bona fide public purposes which are susceptible to mismanagement, with the result that those purposes are not always achieved. In its reformulated state, the standard public interest or 'helping hand' theory of regulation rests on two assumptions:²²

- Unhindered markets often fail because of the problem of monopoly or externalities; and
- Government is benign and capable of correcting these failures through regulation.

The monopolization of unpublished material information by corporate insiders, insider dealing, and non-disclosure are likely to lead to market failure. That is why this article makes a case for effective public regulation of corporate information disclosure and insider dealing, complemented by private enforcement. With proper and effective regulation conducted by the SEC—especially where the SEC adopts a common threshold of materiality for disclosable and insider trading information—these failures can be corrected, yielding market cleanliness, transparency, and investor confidence.

In democratic jurisdictions, the public interest theory of regulation has been used by regulators as both a prescription of what they should do and a description of what they are actually doing. According to this theory, government controls prices so that natural monopolies do not overcharge; regulates safety standards to prevent accidents; and regulates the issuance of securities and other financial products so that investors are not cheated.²³ Samamba²⁴ observes, however, that the public interest theory of regulation is often criticized for exaggerating the extent of market failure and for failing to recognize other mechanisms for addressing and remedying such problems. The criticism proceeds as follows:

- Competition in the market and private orderings can remedy market failures without government intervention at all;

- The problems that survive competition and private orderings may be remedied by private litigation; and
- Even if markets and private ordering fail to solve the problems perfectly well, government and its agencies are often so corrupt, inefficient and incompetent that regulation makes matters even worse.

While these criticisms have merit, the central premise of this article is that effective disclosure regulation requires both public regulation and private regulation—private orderings and private litigation operating together—to produce optimal outcomes.

4. Theories of Corporate Disclosure

The effectiveness of public enforcement partly depends on the effectiveness of the legal and institutional framework. An effective legal and institutional framework governing a given socio-economic sphere is tailored to the encouragement or discouragement of certain behavioral patterns in the conduct of market participants.²⁵

The theories of corporate disclosure predict the actions of market participants. Therefore, if the legal and institutional framework is calibrated to promote or discourage certain behaviour on the part of market players, it is more likely to succeed in regulating corporate information disclosure.²⁶ There are three principal theories of disclosure regulation: the Capital Cost Reduction Theory, the Liquidity Enhancement Theory, and the Hydraulic Theory.²⁷ These theories both elaborate the case for corporate disclosure regulation and clarify the arguments regarding the necessity of protecting against externalities arising from under-disclosure as well as excessive disclosure.

4.1 Capital Cost Reduction Theory of Disclosure

The Capital Cost Reduction Theory of Disclosure posits that increased corporate disclosure directly lowers the cost of capital for issuers and enhances firm value. This theory is rooted in Merton's 1987 model.²⁸ In Merton's model, investors exhibit varying levels of market knowledge. Some have complete information, while others possess only incomplete information—specifically, a lack of awareness of all issuers participating in the economy. This incomplete knowledge leads to sub-optimal risk sharing and market inefficiency. As unknown issuers increase their disclosure, they become known to investors who previously had

incomplete information, thereby expanding their investor base and enhancing risk sharing, which in turn reduces the cost of capital.²⁹

According to Samamba,³⁰ the Merton Model raises the question as to how the investor base is actually priced in equilibrium. There is also an offshoot of this theory premised on estimation risk—the estimation of the beta of a firm, and the role of information (disclosures) in that estimation.³¹ Once these two aspects are identified, the informational element is modeled based on a historical time series of returns, from which two streams are generated:

- i) The equal information stream, where the same historical series of returns is accessible to all firms in the economy; and
- ii) The unequal information stream, where some firms have a longer time series of returns compared to others.

The studies by Barry and Brown, and Coles et al., reveal that better-informed securities holders in the unequal information stream have a lower beta compared to those in the equal information stream.³² However, these studies fail to address the differences in betas among less-informed securities holders within the asymmetric information stream compared to the equal information stream, nor do they explain how firm-specific information might affect the cost of capital in the asymmetric information stream. Despite these shortcomings, the studies generally indicate that disclosure can reduce the cost of capital for firms.³³

Lambert, Leuz, and Verrecchia³⁴ conducted a study re-evaluating the relationship between estimation risk and a firm's cost of capital. Using a traditional information-economics approach, they connected information signals to actual or future cash flows, permitting general informational changes and analyses of firm-specific information. The study found that as disclosure increases, the covariances of a firm's cash flows with those of other firms decrease, thereby bringing the firm's cost of capital closer to the risk-free rate.³⁵

One of the primary reasons issuers seek to raise capital in foreign markets is to benefit from a lower cost of capital. Due to the empirical link between improved corporate disclosure and reduced capital costs, issuers tend to migrate to securities markets with more stringent regulatory rules and a strong track record of effective enforcement. This aligns with the bonding theory, which suggests that issuers will migrate to foreign markets only where those

markets offer higher quality regulatory rules and enforcement compared to their home markets.³⁶

4.2 Liquidity Enhancement Theory of Disclosure

Liquidity is the ability of a securities market to facilitate trading in large quantities of securities within a short time without significant movement in the price of those securities. There are four dimensions to securities market liquidity: the time dimension; the cost dimension; the volume dimension; and the price effect dimension.³⁷ These are often reflected in the four basic characteristics of liquidity: depth, breadth, resilience, and immediacy.

As Mwenda explains:

Firstly liquidity refers to 'a market's ability to provide immediate execution for an incoming market order (often called immediacy) and the ability to execute small market orders without large changes in the market price (often called depth or resiliency).' These simple definitions of market liquidity reflect two dimensions of a desired transaction—namely, speed (transaction time) and price (transaction cost). The speed dimension involves the timeline of liquidity. Based on this dimension, the liquidity of a stock issue means that transactions of its shares are immediately available. Yet, demanders of immediacy can usually get rapid trade execution if they are willing to incur inferior trading terms. Therefore the second dimension of a liquidity market is achieving immediacy at minimal cost.³⁸

The Zambian securities market is in the nascent stage of development, characterized by low trading volumes. This context is directly relevant to the Liquidity Enhancement Theory of Disclosure.

The Liquidity Enhancement Theory of Disclosure is premised on the idea that information imbalances among investors in securities markets result in adverse selection. Adverse selection occurs when investors exercise excessive caution in deciding when, with whom, and how much to trade. In scenarios of information imbalance, less informed investors are constantly concerned about trading with those who possess superior information—specifically, that better informed investors may be willing to buy or sell securities at a certain price solely because it

is lower or higher than it would be if undisclosed price-sensitive information were made public.³⁹

Well-informed traders may therefore need to adjust their bids and asks accordingly. These adjustments fundamentally reflect the informational advantage held by informed investors. One way to mitigate the negative effects of this informational advantage is through bid-and-ask spreads in secondary trading markets.⁴⁰ Fluctuations in security prices arising from information asymmetry can contribute to market volatility, potentially prompting panic buying and selling, thereby decreasing the number of trades and overall liquidity in the securities market. To mitigate information asymmetries and adverse selection, and to boost investor confidence and promote securities trading, it is therefore advisable to advocate for and improve the quality of corporate disclosure.⁴¹

The Duty of the Insider to Disclose Unpublished Material Information

A further means of mitigating the adverse impact of adverse selection is to impose on the insider who possesses unpublished material information a duty to disclose that information to the uninformed counterparty. Although Zambian law does not currently provide for such a duty,⁴² the law of the United States imposes a duty on a trader in possession of inside information to either refrain from trading or disclose the inside information to the other party.⁴³ By section 137(b) of the Securities Act, 2016, an insider in Zambia is under an obligation to make disclosures as may be prescribed. Since no prescription has yet been laid down, it is recommended that a statutory instrument be issued outlining the prescribed disclosures.

Corporate disclosure contributes to the liquidity of securities markets through two main mechanisms:⁴⁴

- iii) By increasing the flow of information available to the public, corporate disclosure renders it unnecessary for traders to seek private information. This reduces the cost associated with unpublished information similar to disclosed information, thereby diminishing the number of trades influenced by information asymmetry.
- iv) When investors have certainty regarding the true condition of the issuer, its business, and its securities, they are less susceptible to adverse selection. Consequently, they are more inclined to participate in transactions, leading to a higher volume of orders—both

actual and potential—thereby deepening and broadening the market and ultimately enhancing its liquidity.

4.3 Hydraulic Theory of Disclosure

The Hydraulic Theory of Disclosure suggests that when disclosure regulations impose costs on certain behaviours such as non-disclosure, they are more likely to prompt changes in behaviour than to foster an increase in information flow. This occurs as long as the targeted behaviour can be modified at a cost lower than the cost of disclosure.⁴⁵

The rationale underlying this theory is that if private investors hold undisclosed price-sensitive information that is deemed valuable, the challenge for regulators in enforcing disclosure can be significant. Those possessing such information—whether issuers or investors—will only be inclined to disclose it if the benefits outweigh the associated costs.⁴⁶ This perspective advocates for a legal, regulatory, and institutional framework capable of effectively ensuring disclosure. Consequently, regulatory rules that promote compliance at minimal expense are likely to incentivize disclosure by both issuers and investors. The potential benefits of enhanced disclosure—such as increased liquidity and lower cost of capital—would outweigh the relatively low compliance costs.

Nevertheless, if the expense of changing the targeted behaviour exceeds the cost of disclosure—either because the overall costs of disclosure are relatively minimal or externalized, or because alternative behaviours are more costly—disclosure regulations may struggle to effectively deter the undesirable behaviour.⁴⁷ As a possible means of guarding against the externalities that may arise from such uncertainty and to yield optimal regulatory results, Samamba⁴⁸ proposes the following regulatory measures:

- v) Effective regulatory rules for the targeted behaviour;
- vi) Effective mechanisms for the enforcement of those regulatory rules;
- vii) An effective institutional framework which facilitates compliance with the regulatory rules at minimum cost;
- viii) Effective regulatory rules for other forms of behaviour that could serve as substitutes for the primary (targeted) behaviour—including insider dealing as a substitute for

corporate disclosure;

- ix) Effective enforcement of the regulatory rules for the possible substitute behaviour; and
- x) Regulatory rules for the possible substitute behaviour that facilitate compliance at minimum cost.

In relation to the dichotomous approach to corporate information disclosure, the Hydraulic Theory suggests that where regulatory rules for corporate disclosure are weak or where enforcement is lax, market players are likely to resort to related behaviours—such as insider dealing—which are nuanced substitutes for non-disclosure.

5. Conclusion

This article has examined the role which the theories of corporate disclosure and public regulation play in ensuring effective corporate disclosure regulation and has made a case for public regulation. The conclusion advanced is that, for corporate information disclosure and insider dealing enforcement to be effectively pursued, there is a need for public regulation that is complemented by private enforcement.

Furthermore, the theories of corporate information disclosure—the Capital Cost Reduction Theory, the Liquidity Enhancement Theory, and the Hydraulic Theory—can be used to predict the behavioural patterns of market players. By incorporating these theories into the legal and institutional framework, the regulation of corporate information disclosure and insider dealing is likely to be rendered more effective, thereby promoting market cleanliness, transparency, and investor confidence. It is therefore recommended that the Securities and Exchange Commission of Zambia adopt a common threshold of materiality for both disclosable information and insider trading information, as this would serve as a unifying standard that strengthens both regulatory regimes simultaneously.

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18 The other costs include formulation and implementation costs, maintenance and enforcement costs, compliance costs, and dead-weight costs.

19 The constraint relating to the lack of civil remedies for pecuniary injury occasioned by insider dealing or non-disclosure is a significant gap in the current Zambian regulatory framework.

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44 Verrecchia (n 41).

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46 Insider trading laws expressly or impliedly impose a duty on investors in possession of unpublished price-sensitive information to either disclose it to the other party to a securities transaction or refrain from trading altogether.

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