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SEC ADOPTS SELECTIVE DISCLOSURE RULES

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In spite of strong criticism from a variety of market participants, the SEC has adopted Regulation FD (Fair Disclosure) in response to concerns about selective disclosure of material nonpublic information to securities analysts, institutional investors and others. In addition, the SEC has adopted new rules to "clarify and enhance" the law of insider trading. In response to comments, the SEC has narrowed the scope of Regulation FD from that proposed in its December 1999 proposing release (the "Proposing Release").

Regulation FD provides the SEC with enforcement authority to address selective disclosure. While some commenters contended that rulemaking was an inappropriately broad response to selective disclosure, the SEC viewed its existing regulatory tools (namely actions based on insider trading), as well as a system of voluntary self-regulation or best practices developed by a panel of experts, as inadequate to address what it views as a pervasive problem.

The SEC, by its rulemaking, formally adopted:

- a regulation under the 1934 Act that requires domestic reporting companies that intentionally disclose material information to securities market professionals, or to holders of the issuer's securities under circumstances in which it is reasonably foreseeable that the holder will trade on the basis of the information, to do so through public disclosure, and to make prompt public disclosure of information whenever they learn that they "unintentionally" made material selective disclosure. To address criticism that the regulation would have a chilling effect on corporate communications, the SEC:

    - narrowed the scope of the regulation so that it applies only to communications to persons who reasonably could be expected to trade securities on the basis of the communication or advise others about trading, namely securities market professionals and shareholders under circumstances where it is reasonably foreseeable that they will trade on the information;

    - narrowed the coverage to senior officials of the reporting company and persons who regularly communicate with securities market professionals or security holders;

    - clarified that there is no private right of action in respect of violations of the regulation;

    - clarified that liability only arises where covered persons know or are reckless in not knowing that the information selectively disclosed is both material and nonpublic; and

    - provided that a violation of the regulation would not result in loss of eligibility to use short-form registration or affect the ability of security holders to resell under Rule 144.

The SEC also formally adopted:

- a general principle of insider trading liability that imposes liability on persons who trade while "aware" of material nonpublic information. Rule 10b5-1 also establishes three affirmative defenses to liability where a trade resulted from a pre-existing plan, contract or instruction that was made in good faith. The rule represents the SEC's response to the unsettled issue of whether a defendant in an insider trading action must be shown to have *used* inside information, or merely to have traded while *in possession* of inside information.

- the position that the "misappropriation" theory of insider trading can be applied (under Rule 10b5-2) in the following circumstances:

    - when a person agreed to keep the challenged information confidential;

    - when the people involved in the communication had a history, pattern or practice of sharing confidences that resulted in a reasonable expectation of confidentiality; and

    - when the person providing the information was a spouse, parent, child or sibling of the recipient, unless it could be shown that there was no reasonable expectation of confidentiality.

The new regulation and new rules take effect 60 days after publication in the *Federal Register*.

This memorandum summarizes Regulation FD. A separate memorandum is available summarizing the new insider trading rules.

1. Selective Disclosure

Selective disclosure to securities analysts, whether in the course of meetings with analysts or discussions of analyst reports in draft form with analysts, or through quarterly conference calls open only to analysts and selected institutional investors, has been the subject of much attention and criticism from SEC Chairman Arthur Levitt for some time. This has been particularly the case where analysts or institutional investors are given advance notice of quarterly results, which when publicly announced have a predictable and adverse impact on the stock price. In the words of the SEC, "[t]hose privy to selectively disclosed information have an unfair advantage over other investors, who learn of the information only if and when the issuer later makes full public disclosure."

To prompt public companies to provide full and fair disclosure, the SEC has adopted new Regulation FD. Instead of treating selective disclosure as unlawful "tipping" under the insider trading rules, the new regulation requires that when a domestic reporting company intentionally discloses material information, it do so through public disclosure; and whenever a domestic reporting company learns that it unintentionally has made a material selective disclosure, it make "prompt" public disclosure of that information. The reporting company will be able to make the required

public disclosure by filing or furnishing the information on Form 8-K or by alternative means of disclosure that will achieve the goal of broad, non-exclusionary distribution of the information.

Regulation FD has various key elements:

(a) *Disclosure by an Issuer or Person Acting on Behalf of an Issuer*

Regulation FD applies only to domestic reporting companies (issuers with securities registered under Section 12 of the 1934 Act or with a reporting obligation under Section 15(d) of the 1934 Act; this latter group would include issuers of high yield bonds through registered exchange offers). The Proposing Release did not distinguish between U.S. issuers and non-U.S. issuers, but in response to comments, the SEC excluded foreign governments and foreign private issuers from the Regulation. (These issuers, however, are likely to be subject to stock exchange rules regarding public disclosure of material information if they have securities listed in the United States.)

The Regulation applies to selective disclosure made by a person acting on behalf of an issuer, which phrase has been limited to mean only (i) any "senior official" of the issuer, and (ii) any other officer, employee or agent of an issuer who regularly communicates with securities market professionals (broker-dealers, investment advisers, institutional investment managers or investment companies) or with the issuer's security holders. "Senior official" is defined as any director, executive officer, investor relations or public relations officer, or other person with similar functions. This coverage represents a significant scaling back from the definition in the Proposing Release, which covered any officer, director, employee or agent of the issuer while acting within the scope of his or her authority.

The Regulation continues to distinguish between authorized disclosure (which could trigger liability and public disclosure) and unauthorized disclosure by an employee or agent that would constitute unlawful trading or tipping (which might not trigger liability and disclosure).

(b) *Disclosure of Material Nonpublic Information*

The Regulation addresses selective disclosure of material nonpublic information, but, as proposed in the Proposing Release, does not define the term “material.” The SEC believes that the majority of cases will be clear cut even though materiality does not lend itself to any bright line tests. It recommended careful review to determine whether certain types of information or events are material, including: earnings information; mergers, acquisitions, tender offers, joint ventures, or changes in assets; changes in control or in management; changes in auditors; events regarding the issuer's securities; and bankruptcies or receiverships.

Most significantly, in the Proposing Release, the SEC noted that giving guidance or express warnings concerning earnings or sales figures would likely be material, while more generalized background information would likely be less material. In the Adopting Release, the SEC reiterated that a covered person engaging in a private discussion with an analyst who is seeking guidance about earnings estimates takes on a high degree of risk under the Regulation. Selective disclosure that expected earnings are likely to be higher, lower or the same as analyst forecasts would likely constitute a violation of the Regulation. However, the SEC also pointed out that materiality is an

objective test keyed to the reasonable investor, so that immaterial information the significance of which is discerned only by an analyst will not be implicated under the Regulation.

The SEC recognizes that identifying what constitutes material nonpublic information may require difficult judgments, often in situations that require instant responses. This may inhibit communications with analysts and may compel greater involvement by counsel. In the Proposing Release, the SEC suggested various ways of mitigating these concerns, including designating a limited number of persons to deal with analysts, the media and investors; keeping records of the substance of private communications with analysts and investors; declining to answer questions that may raise material issues, pending internal discussions with others; embargoing use of information pending consideration of whether any of the information was material and nonpublic, thereby giving the issuer the opportunity to make corrective public disclosure; and relying on the corrective action called for if unintentional selective disclosure occurs.

(c) *Disclosure to Enumerated Persons*

Commenters were of the view that if the Regulation applied to any person "outside" the issuer, it would inappropriately interfere with ordinary course business communications with parties such as customers, suppliers, strategic partners and government regulators. In response, the SEC narrowed the coverage of the Regulation to four categories of persons. Thus, the rules on selective disclosure apply only to disclosures made to the following categories of persons:

- broker-dealers and their associated persons;
- investment advisers, certain institutional investment managers (those that report on Schedule 13F) and their associated persons;
- investment companies and private investment companies that are exempt from investment company status under Section 3(c)(1) or 3(c)(7) of the Investment Company Act (which would pick up hedge funds, for example) and persons affiliated therewith; and
- any of the issuer's security holders under circumstances in which it is reasonably foreseeable that the holder will trade on the basis of the information.

The Regulation covers persons most likely to receive improper selective disclosure, while generally not covering disclosures to persons who are engaged in ordinary course business communications, disclosures to the media or communications with government agencies.

The Regulation sets forth four exclusions from coverage:

The first exclusion covers disclosures to persons subject to duties of trust or confidence not to disclose the information or use it for trading. This exclusion would cover "temporary insiders" such as attorneys, investment bankers and accountants.

The second exclusion is for disclosures to any person who *agrees* to maintain the information in confidence. This agreement may be written or oral, and may be entered into even after disclosure, so long as the recipient of the information does not disclose or trade based on the information (thus allowing certain unintentional selective disclosure to be swiftly remedied). The SEC noted in its Proposing Release that issuers could share information with other parties to a proposed business combination or with a purchaser in a private placement without having to make the information public, *if the recipient of the information agrees to keep the information confidential.*

A third exclusion covers disclosures to credit rating agencies, provided that the disclosure is solely for the purpose of developing a credit rating and the rating agency's ratings are publicly available.

The final exclusion is for communications made in connection with most registered security offerings. This exclusion is discussed below in subsection (g).

(d) *Timing*

Intentional selective disclosure requires simultaneous corrective action. This requirement in effect means that issuers will not be able to engage in intentional selective disclosure without violating Regulation FD.

Unintentional selective disclosure requires prompt corrective action. "Prompt" is defined for this purpose only (and not for other purposes under the securities laws) to mean "as soon as reasonably practicable" but no later than the later of 24 hours and the commencement of the next day's trading on the New York Stock Exchange after a senior official (the definition of which is given above) of the issuer knows, or is reckless in not knowing, that an unintentional disclosure of information which is both material and nonpublic has been made. The senior official might become aware of the disclosure as a result of seeing a significant change in the trading price or volume of the company's stock or might learn of an unintentional disclosure by another employee when an analyst or investor calls for confirmation of the information.

(e) *Corrective Action through "Public Disclosure"*

Issuers will be able to comply with the public disclosure requirement of the Regulation by filing or furnishing the information on Form 8-K. Alternatively, issuers may disseminate a press release through widely circulated news or wire services, or through any other means reasonably designed to provide broad non-exclusionary access, such as a press conference to which the public is granted access and of which the public has notice. Although the SEC encourages issuers to post information on their corporate web sites when they make public disclosure as described above, the SEC did resist suggestions to treat a web site posting as a sufficient means of public disclosure. The Adopting Release does state that as technology evolves and as more investors have access to the Internet, some issuers whose web sites are widely followed by investors may be able to use such method. Note that the stock exchanges do not treat web site postings as constituting adequate public dissemination of information for purposes of their disclosure rules.

If the issuer wishes to "furnish" the material nonpublic information on Form 8-K, it can do so under Item 9 of the Form. The issuer will not be liable for such information under Section 11 of the 1933 Act or Section 18 of the 1934 Act unless it files it in a separate filed report, proxy statement or registration statement. Alternatively, the issuer may "file" the information on Form 8-K under a modified Item 5. In this case, it will be subject to liability for the information under Section 18 of the 1934 Act, the information will be subject to automatic incorporation by reference into the issuer's 1933 Act registration statements, and the issuer will therefore also be subject to liability for such information under Sections 11 and 12(a)(2) of the 1933 Act. In either event, the SEC has expressly provided that disclosure will not, by itself, be deemed an admission as to the materiality of the information (in case an issuer errs on the side of caution and files information which, in retrospect, it does not deem material).

The SEC has recommended a model employing a combination of methods of disclosure, for making a planned disclosure of material information, such as a scheduled earnings release:

- First, issuance of a press release, distributed through regular channels, containing the information;

- Second, provision of adequate notice, by press release and/or web site posting, of a scheduled conference call to discuss announced results, including time and date of conference call and instructions on how to access the call; and

- Third, holding the conference call in an open manner, allowing investors to listen in either telephonically or through Internet webcasting.

By following this approach, a company can use the press release to provide the initial broad dissemination of the information, and then discuss the substance with analysts in a subsequent conference call without fear that if it should disclose additional material details related to the original disclosure it will be selectively disclosing the new information.

In general, the SEC states that deviation from an issuer's usual practices for making public disclosure may affect its judgment as to whether the method of public disclosure in a given case was reasonable.

(f) *Liability Issues*

Failure by an issuer to comply with Regulation FD could subject the issuer, or an individual at the issuer responsible for the violation, to SEC enforcement action. In this context, the SEC states that while it has not mandated the adoption of policies and procedures to avoid violations, it expects issuers to use them as a safeguard against selective disclosure, and it may find the existence of an appropriate policy, and an issuer's adherence to it, relevant in determining an issuer's intent with regard to a selective disclosure.

In addition, selective disclosure may give rise to liability for tipping under insider trading rules, if it can be established that the tipper derived a "personal benefit" from the disclosure. Failure to make a public disclosure might also give rise to liability under traditional notions of a duty to

update or duty to correct prior statements. An issuer's involvement with the preparation of an analyst's report could also give rise to liability under "entanglement" or "adoption" theories.

The SEC has, however, made it clear that the Regulation is not intended to create new duties under the antifraud provisions of the federal securities laws or in private rights of action, and the Regulation expressly provides that no failure to make a public disclosure required *solely* by Regulation FD shall be deemed to be a violation of Rule 10b-5. An issuer, however, could face liability under the general antifraud provisions of the 1934 Act if a public disclosure contained material misstatements or material omissions.

(g) *Registered Offering Issues*

Communications made in connection with most registered security offerings are excluded from the application of Regulation FD (contrary to what was suggested in the Proposing Release). For these purposes, the SEC has defined when offerings are considered to begin and end. An underwritten offering is deemed to commence when the issuer "reaches an understanding" with the broker-dealer that is to act as managing underwriter and continues until the later of the end of the period during which each dealer must deliver a prospectus or the sale of the securities (unless the offering is sooner terminated).

Non-underwritten offerings are split into three categories for purposes of the Regulation. A shelf registration of securities is deemed to commence when the issuer makes its first bona fide offer in a takedown of securities and continues until the later of the end of the period during which each dealer must deliver a prospectus or the sale of the securities in that takedown (unless the offering is sooner terminated). An offering involving a business combination under Rule 165(a) (such as a reclassification, merger, consolidation or transfer of assets) which requires a security holder vote, or an exchange offer, is deemed to commence when the first public announcement of the transaction is made and continues until the completion of the vote or the expiration of the tender offer, as applicable (unless the transaction is sooner terminated). All other non-underwritten offerings are deemed to commence when the issuer files a registration statement and continue until the later of the end of the period during which each dealer must deliver a prospectus or the sale of the securities (unless the offering is sooner terminated).

(h) *Unregistered Offering Issues*

Disclosure of material nonpublic information in connection with unregistered security offerings (such as private placements) is not excluded from the application of Regulation FD. This means that issuers must either obtain confidentiality agreements with prospective investors in unregistered offerings, or broadly disclose all material nonpublic information they reveal to such investors.

(i) *Eligibility for Short-Form Registration and Rule 144*

To avoid the harsh result of loss of availability of short-form registration due to a failure to file a Form 8-K when no other qualifying public disclosure is made, the SEC has included a provision in the Regulation that an issuer's failure to comply with the Regulation will not affect

whether it is considered current or, where applicable, timely in its 1934 Act reports for purposes of Form S-8, short-form registration on Form S-2 or S-3 and Rule 144.

2. Impact

As the selective disclosure rules go to the heart of corporate disclosure practices, they are likely to cause market participants to adopt over the coming weeks a "wait-and-see" approach until the dust settles. Although public companies have the technological means, and should, open their quarterly conference calls to the public and make them accessible via webcasts, one-on-one conversations with analysts, investment conferences and in-person analyst meetings traditionally have been significant sources of information for analysts and, in turn, the marketplace, and are less susceptible to bright-line rules. These discussions may require greater scrutiny by counsel to determine whether statements made are in fact material and certainly tighter disclosure procedures for senior management and corporate spokespersons. In this connection, reporting companies should review their corporate disclosure policies to minimize the potential for selective disclosure and to ensure that their customary dissemination policies are adequate.

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The foregoing memorandum provides only a general overview of the SEC's Regulation FD. It is not intended to provide legal advice, and no legal or business decision should be based on its content.

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