

SEC Adopts Significant Selective Disclosure and Insider Trading Rules

The SEC recently adopted new rules intended to address selective disclosure and to clarify the scope of certain insider trading prohibitions.¹ The new rules are based on rules first proposed for comment in December 1999 and will take effect October 23, 2000. Regulation FD (Fair Disclosure), the new rule on selective disclosure, is a particularly important development in the SEC's regulation of the securities markets. This new regulation will bring SEC oversight directly into the investor relations process. At the same time, the regulation does not include "bright-line" rules with clear guidance. Issuers will need to review their compliance programs and develop guidelines for dealing with the investment community to ensure that their practices comply with this new regulation.

A. Selective Disclosure: Regulation FD

Selective disclosure occurs when a company releases material nonpublic information, such as upcoming earnings information, to securities market professionals or major investors before disclosing the information to the public. The SEC perceives that there often is an unstated expectation that analysts receiving such information will "reward" the company by providing positive coverage. The SEC believes that those who receive this nonpublic information are given an advantage over others who learn of the information only upon a public disclosure by the company, leading to concerns about the integrity of our capital markets. Regulation FD is intended to prohibit selective disclosure to the professional investment community and to encourage broad public disclosure.

Regulation FD was passed despite the concerns of SEC Commissioners Isaac Hunt, Jr. and Laura Unger about the potential "chilling effect" of the regulation on corporate communications, which instead of leading to greater availability of information could result in a marked reduction in the frequency and extent of corporate communications to investors. After the scope of the regulation was modified and narrowed as a result of the comment process, the SEC approved it with a 3-1 vote, with Commissioner Laura Unger dissenting out of a belief that Regulation FD still "casts too wide a net."

1. See Securities Act Release No. 33-7881, Exchange Act Release No. 34-43154, IC Release No. IC-24599 (Aug. 15, 2000) ("release"). The release may be found at <<http://www.sec.gov/rules/final/33-7881.htm>>.

Corporate communications will change significantly as a result of Regulation FD. For example, the SEC warns in the adopting release that the common practice of providing “guidance” on earnings forecasts to analysts, if made in a private discussion, likely violates Regulation FD. The release does note that an issuer may disclose a non-material piece of information to an analyst, even if that non-material piece enables the analyst to complete a “mosaic” of information that, taken together, yields material nonpublic information. Nonetheless, it is fair to conclude that Regulation FD will dramatically affect the means by which companies deal with analysts and may significantly modify the way information is communicated to investors.

1. Applicability

Regulation FD applies only to issuers that have a class of securities registered under Section 12 of the Securities Exchange Act of 1934 or are required to file reports under Section 15(d) of the Exchange Act, including closed-end investment companies but not other investment companies. Foreign government issuers and foreign private issuers are exempted from the new rules. For reporting issuers, communications in connection with a private placement are covered under the new rules (unless the recipient expressly agrees to keep the information confidential), while communications in connection with a registered public offering (other than a shelf registration) are excluded from those rules in light of the SEC view that the Securities Act of 1933 already achieves at least some of the policy goals of Regulation FD in the context of registered offerings. The SEC notes in its release, however, that communications in a regularly scheduled analyst conference call relating to future financial performance, even if the call occurs at a time when the issuer is in the middle of a registered offering, would not be considered communications made in connection with the offering and would, therefore, not fall under the exclusion.

Regulation FD applies to communications by senior management, investor relations professionals and others who regularly communicate with securities market professionals and security holders on behalf of the issuer. The regulation also covers communications by any person directed by a member of senior management to make a disclosure. It is intended to cover communications made to securities market professionals and to holders of the issuer's securities under circumstances in which it is reasonably foreseeable that the holders will trade on the basis of such information.

Regulation FD does not apply to communications with the media, rating agencies, ordinary-course business communications with customers and suppliers, communications made to any person who owes the issuer a duty of trust or confidence (*e.g.*, a “temporary insider,” such as an attorney, investment banker or accountant) or communications made to any person who has entered into an express confidentiality agreement with the issuer (whether written or oral). An issuer, for example, could disclose material nonpublic information to a party in connection with a proposed business combination transaction or to a purchaser in a private placement without having to make public disclosure, if the recipient expressly agrees to keep the information confidential.

2. The Disclosure Obligation

Under Regulation FD, when an issuer learns of an *unintentional* disclosure of material nonpublic information, the issuer must make *prompt* public disclosure of that information. The regulation provides that an issuer “learns” of a disclosure when a senior official knows (or is reckless in not knowing) that a disclosure of both material and nonpublic information has been made. “Prompt” disclosure means as soon as reasonably practicable, but no later than either 24 hours after discovery of the unintentional disclosure or prior to the commencement of the next day’s trading on the New York Stock Exchange, if later. When an issuer makes an *intentional* disclosure of material nonpublic information, the issuer must *simultaneously* make public disclosure of the same information.

3. Materiality Judgments

The SEC declined to create a new standard with respect to materiality for purposes of the new regulation. Regulation FD relies on existing case law and recent Staff guidance to determine the standard of materiality.² The release identifies several types of information or events that might be considered material under certain circumstances, although the SEC notes that the list is not exhaustive. The release emphasizes that the materiality of each must be judged on a case-by-case basis:

- earnings information;
- mergers, acquisitions, tender offers, joint ventures, or changes in assets;
- new products or discoveries, or developments regarding customers or suppliers (*e.g.*, the acquisition or loss of a contract);
- changes in control or in management;
- change in auditors or auditor notification that the issuer may no longer rely on an auditor’s audit report;
- events regarding the issuer’s securities (*e.g.*, defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities); and
- bankruptcies or receiverships.

2. The release points to several sources as providing guidance on the existing standard of materiality, citing, *e.g.*, *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (information is material if “there is a substantial likelihood that a reasonable [investor] would consider it important” in making an investment decision); *Basic v. Levinson*, 485 U.S. 224, 231 (1988) (materiality with respect to contingent or speculative events will depend on a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of company activity); and Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 12, 1999) (discussing qualitative factors to be considered in assessing an item’s materiality).

As noted above, the release warns about “the high degree of risk under Regulation FD” of the common practice of privately providing “guidance” to analysts with respect to earnings forecasts. The challenge in complying with Regulation FD for those responsible for an issuer's communications will be to make the appropriate judgments concerning the materiality of information being disclosed.

4. Means of Making the Required Disclosure

Under the regulation, an issuer can make the required public disclosure by:

- “filing” the information under Item 5 of Form 8-K, or “furnishing” the information under a new Item 9 of Form 8-K;³ or
- any other method (or combination of methods) of disclosure that is “reasonably designed to provide broad non-exclusionary distribution of the information to the public” (*e.g.*, a press release or an announcement at a press conference to which the public is granted access, either by personal attendance, telephonic access or Internet webcasting).

The release recommends a model combination of methods for issuers making a planned disclosure of material information: (1) issue a press release containing the information, (2) provide adequate notice (*e.g.*, through a press release) of a conference call to discuss the information, and (3) hold a conference call to which the public is granted access and may listen in. Given that this practice has the SEC seal of approval, many companies may adopt the foregoing practice in order to ensure compliance with Regulation FD.

The release also specifically states that merely posting information on the issuer's website is not, by itself, considered sufficient public disclosure. However, the SEC notes that, in time, as more investors gain access to the Internet, some issuers whose websites are closely followed by the investment community may be able to satisfy their disclosure obligations solely by posting the information on their websites.

5. Additional Considerations

The regulation provides that failure by an issuer to make a public disclosure that is required solely by Regulation FD will not be deemed to be a violation of Rule 10b-5. It is

3. If an issuer chooses to “furnish” the information, the disclosure will not subject the issuer to liability under Section 11 of the Securities Act or Section 18 of the Exchange Act, unless the issuer includes that disclosure in a filed report, proxy statement, or registration statement. In addition, information “furnished” under Item 9 of Form 8-K will not be automatically incorporated by reference into the issuer's Securities Act registration statements. All disclosures on Form 8-K, whether filed or furnished, remain subject to the antifraud provisions of the securities laws. See release pt. II.B.4.a.

important to remember, however, that parties can still be subject to liability under Rule 10b-5 for “tipping.” Regulation FD is intended to provide the SEC with sole enforcement power, pursuant to which it could bring an administrative proceeding seeking a cease and desist order or a civil action seeking an injunction and civil penalties. Filings made pursuant to Regulation FD will still be subject to existing rules concerning false or misleading information. In addition, a violation of Regulation FD will not preclude the use of short-form registration statements that require current and timely Exchange Act filings, or affect an investor's ability to resell under Rule 144.

B. New Rules Concerning Insider Trading

The SEC also adopted two new rules clarifying the scope of certain aspects of insider trading prohibitions.

1. Use vs. Possession: 10b5-1

In recent cases, courts have differed with the SEC on the issue of whether, in order to impose liability for insider trading, it must be established as one of the elements of the offense that a trader “used” the inside information received, or if it is enough to establish that the trader “possessed” the information at the time of the trade. The SEC has adopted Rule 10b5-1, which provides that a person trades “on the basis of” material nonpublic information about a security when the person is “aware” of that information at the time of the purchase or sale of the security. The Preliminary Note to Rule 10b5-1 expressly states that the new rule is not intended to modify any other aspect of insider trading law that has been established by the courts under Rule 10b-5.

The rule sets forth several affirmative defenses to permit persons to trade in certain circumstances where it is clear that the information was not a factor in the decision to trade. Under the new rule, no liability would result if:

- (i) before becoming aware of the information, the trader had entered into a binding contract to purchase or sell the security, instructed another person to purchase or sell the security for the instructing person's account, or adopted a written plan for trading securities;
- (ii) the contract, instruction, or plan
 - specified (or included a written formula or algorithm, or computer program, for determining) the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or

- did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material nonpublic information when doing so; and
- (iii) the purchase or sale that occurred was pursuant to the contract, instruction, or plan.

The foregoing defenses apply only if the contract, instruction or plan to trade was made in good faith, and not as part of a plan or scheme to evade the prohibitions of the rule. The SEC noted these defenses would be available to issuers operating repurchase programs or employees adopting plans for exercising stock options, so long as certain conditions were met.

The new rule contains one additional defense available only to entities. Such an entity must demonstrate that (1) the individual(s) making the decision on behalf of the entity was not aware of the inside information, and (2) the entity had in place reasonable policies and procedures to ensure that insider trading prohibitions are not violated.

2. Family Relationship and Misappropriation: 10b5-2

The misappropriation theory, upheld by the Supreme Court in 1997,⁴ requires a breach of fiduciary duty or other relationship of trust for insider trading liability. Such relationships include, for example, those between attorney and client, so that a lawyer who uses material nonpublic client information for trading purposes violates the securities laws. However, it is less clear how the misappropriation theory applies in the context of family or other non-business relationships.

New Rule 10b5-2 clarifies the issue of when a breach of a family or other non-business relationship may give rise to liability under the misappropriation theory. It is designed to apply to all misappropriation theory cases, including trading or tipping. It provides that if a person receiving confidential information agrees to keep, or is under a reasonable expectation of keeping, the information confidential, or receives the information from a spouse, parent, child, or sibling (unless there is no reasonable expectation of confidentiality), then the recipient owes a duty of trust or confidence to the person from whom he or she received the information and therefore, may be liable under the misappropriation theory if he or she then trades.

4. *United States v. O'Hagan*, 521 U.S. 642 (1997).

If you have any questions about these rules, would like a copy of the release, or would like assistance in updating your communications with analysts or insider trading policies, please call your usual Skadden, Arps contact.

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