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The Missing Piece of the Mosaic: Improving Regulation FD

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THE MISSING PIECE OF THE MOSAIC: IMPROVING REGULATION FD

I. INTRODUCTION

The practice of selective disclosure, which occurs when a stock issuer provides material, non-public information about a company to a stock analyst before disclosing it to the general public,[1] continues to trouble the SEC.[2] The SEC encourages issuers to disclose information to analysts in order to enhance market efficiency;[3] however, the SEC prohibits issuers from disclosing *material* information to analysts, finding such disclosures unfair to the investing public.[4] Furthermore, the SEC fails to clearly define materiality, adopting the amorphous reasonable person standard for materiality developed in existing case law.[5] As a result, the SEC provides issuers little guidance as they attempt to disclose important, but not material, information to analysts.[6]

The SEC traditionally proscribed selective disclosure under insider trading law, imposing liability for any trading that occurred on the basis of selectively disclosed material information.[7] The Supreme Court, however,

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1. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts. 240, 243, 249) [hereinafter Final Rule]. Issuers selectively disclose information to various persons, but this Note focuses on selective disclosure to analysts.

2. *See* Paul P. Brountas, Jr., *Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts*, 92 COLUM. L. REV. 1517, 1531-33 (1992) (noting that the SEC attempts to maintain markets that are both fair and efficient, concerns that conflict in the context of selective disclosure).

3. *See id.* at 1533 ("The securities market is said to be efficient when stock prices fully reflect all available information relevant to stock values."). The prevailing theory of market efficiency is the Efficient Capital Market Hypothesis (ECMH), which indicates that when new information becomes available, it is promptly incorporated in the price of the stock through trading. *Id.* at 1532. For further discussion of pricing efficiency, see generally Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988) (discussing the ability of the market to incorporate available information).

4. *See* Brountas, *supra* note 2, at 1531 (discussing the role of fairness in the SEC's disclosure policy). The SEC premised Regulation FD ("Fair Disclosure") primarily on fairness considerations. *See* discussion *infra* Part II.C.1.

5. *See* discussion *infra* Part II.C.3. *See also* Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988). In *Basic*, the Supreme Court adopted the materiality standard articulated in *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). *Id.* at 232. This standard provides that information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision. 426 U.S. at 449. In addition, there must be a substantial likelihood that a fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.*

6. *See* Brountas, *supra* note 2, at 1524-25 (noting that the materiality standard places issuers in a difficult situation with respect to disclosure to analysts).

7. *See id.* at 1528-29 (discussing traditional liability for selective disclosure). *See also* discussion *infra* Part II.A.2. *See generally* Kimberly D. Krawiec, *Fairness, Efficiency, and Insider*

rejected the SEC's "disclose or abstain" rule, stating that such a rule would inhibit the communications between issuer and analyst that are crucial for market efficiency.[8] The Court noted that the imprecise materiality standard provided by the SEC[9] would render a "disclose or abstain" rule unworkable because it failed to provide analysts or issuers proper guidance for structuring communications.[10]

The SEC addressed its inability to prohibit selective disclosure under insider trading law[11] with the adoption of Regulation FD ("Fair Disclosure"), which prohibits such disclosures under the reporting requirements.[12] Regulation FD provides that when an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons,[13] the issuer must make that information publicly available.[14] Under Regulation FD, the SEC expressly authorized issuers to selectively disclose immaterial information;[15] however, it did not define materiality, relying instead on the definition developed in case law.[16] The SEC stated that a general definition of materiality was necessary in order to provide the flexibility to weigh the facts and circumstances of each case.[17]

The Proposing Release[18] of Regulation FD generated many comments on the materiality standard.[19] Many commenters, including securities industry representatives, securities lawyers, and some issuers, asserted that

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Trading: Deconstructing the Coin of the Realm in the Information Age, 95 Nw. U. L. Rev. 443, 450-59 (2000) (analyzing the fairness/efficiency controversy in the context of insider trading).

8. Dirks v. SEC, 463 U.S. 646, 658 (1983) ("Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market.").

9. *Id*. at 659 n.17 (noting that SEC guidance on materiality was "inherently imprecise").

10. *Id*. (stating that "[u]nless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed").

11. *See* Final Rule, *supra* note 1, at 51,716 & n.7 (stating that the status of selective disclosure under insider trading law is unclear due to the Supreme Court's decision in *Dirks v. SEC*).

12. Regulation FD, 17 C.F.R. §§ 243.100-243.103 (2001).

13. *Id*. at § 243.100(b)(1). *See infra* note 73.

14. *Id*. at § 243.100(a).

15. Final Rule, *supra* note 1, at 51,722 ("[A]n issuer is not prohibited from disclosing a non-material piece of information to an analyst.").

16. *Id*. at 51,721. *See supra* note 5.

17. *Id*. The SEC stated, "[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over- or under-inclusive." *Id*. (quoting Basic, Inc. v. Levinson, 485 U.S. at 236).

18. Selective Disclosure of Insider Trading, 64 Fed. Reg. 72,590 (Dec. 28, 1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, and 249) [hereinafter Proposing Release].

19. Final Rule, *supra* note 1, at 51,721.

the general materiality standard was too vague for issuer personnel to use in making real time disclosure judgments under Regulation FD.[20] Commenters claimed that Regulation FD would produce a "chilling effect" on informal communication by inhibiting an issuer's ability to provide immaterial information for fear that the information may be deemed material.[21]

Although adopted on October 23, 2000, Regulation FD remains a contentious area of the law.[22] Regulation FD was intended to "level [the] playing field" between individual investors and market insiders by encouraging broad dissemination of information.[23] However, in its haste to protect the investing public from the unfairness of selective disclosure, the SEC ignored the Supreme Court's earlier warning and created risks to market efficiency by prohibiting selective disclosure without providing a clear materiality standard.[24] As a result, Regulation FD threatens to imperil market efficiency, which may harm the investors the SEC intended to protect.[25]

The SEC should amend Regulation FD to include a bright-line

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20. *Id*. *See, e.g.*, Letter of the Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association to Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73199/keller2.htm (May 8, 2000) (stating that materiality standard was too unclear and complex a standard for issuer personnel to use in making real time judgments about disclosure) [hereinafter ABA Letter]; Letter of the Securities Industry Association to Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73199/spencer1.htm (Apr. 6, 2000) (stating the vagueness of the standard would lead to litigation and a chilling effect on corporate disclosure) [hereinafter SIA Letter]. *But, cf.*, Letter of the Financial Executives Institute to Securities Exchange Commission *at* http://www.sec.gov/rules/proposed/s73199/ameen1.htm (Apr. 24, 2000) ("Materiality is inevitably a judgement (sic) call, easy to make at the extremes, and often difficult inside the range. We do not believe definition beyond what is already in the release would change this circumstance.").

21. Final Rule, *supra* note 1, at 51,721. *See, e.g.*, ABA Letter, *supra* note 20 ("[W]e are concerned that the rulemaking approach proposed by the Commission . . . runs a significant risk of chilling the accelerating pace of information flow to the markets.").

22. *See* American Bar Association Section of Business Law Committee on Federal Regulation of Securities, *Report on Regulation FD* (2002), *at* http://www.abanet.org/buslaw/fedsec/20020206report.pdf (stating that Regulation FD has continued to be controversial) [hereinafter ABA Report].

23. Final Rule, *supra* note 1, at 51,716. "[M]any issuers are disclosing important nonpublic information . . . to securities analysts or selected institutional investors or both, before making full disclosure of the same information to the general public. Where this has happened, those who were privy to the information beforehand were able to make a profit or avoid a loss at the expense of those kept in the dark." *Id.*

24. *See* discussion *infra* Part II.B.

25. *See* Jason Michael Craft, *What's All the Commotion?: An Examination of the Securities and Exchange Commission's Regulation FD*, 14 DEPAUL BUS. L.J. 119, 160 (2001) ("It is likely that through the effects of Regulation FD, the SEC will actually have hurt the individual investor as well as the stability and efficiency of the market as a whole."). For a discussion of the value analysts provide to investors, see *infra* Part II.A.1.

definition of materiality. A clearer standard would allow Regulation FD to operate as envisioned by the SEC, preventing the selective disclosure of material information without chilling the dissemination of immaterial information.[26]

Part II of this Note will examine the historical legal treatment of selective disclosure and the Regulation FD initiative. Part III will examine Regulation FD's effects on market efficiency. Finally, Part IV will propose that the SEC should improve Regulation FD by providing a bright-line definition of materiality.

II. HISTORY

A. The Traditional Role of Security Analysts

1. Providing Value

The SEC has long acknowledged that stock analysts play a crucial role in marketplace efficiency by disseminating additional information into the market that is incorporated into market prices.[27] Analysts collect and analyze information about issuers, markets, and general economic conditions.[28] "A skilled analyst with knowledge of the company and the industry may piece seemingly inconsequential data together with public information into a mosaic which reveals material non-public [sic] information."[29] This process of "completing the mosaic"[30] requires market

26. Despite commenters' concern that Regulation FD would impair market efficiency by restricting issuer communications, the SEC continued to assert that Regulation FD would in effect promote market efficiency by encouraging broader disclosure of information. Final Rule, *supra* note 1, at 51,719 ("Regulation FD . . . should promote full and fair disclosure of information by issuers and enhance the fairness and efficiency of our markets.").

27. *See* Raymond L. Dirks, Exchange Act Release No. 17,480, 191 Fed. Sec. L. Rep. (CCH) ¶ 83,939, at 83,945 (Jan. 21, 1981), *rev'd by* Dirks, *supra* note 8.

> Such individuals are in the business of formulating opinions and insights—not obvious to the general investing public—concerning the attractiveness of particular securities. In the course of their work, analysts actively seek out bits and pieces of corporate information not generally known to the market for the express purpose of analyzing that information and informing their clients who, in turn, can be expected to trade on the basis of the information conveyed. The value to the entire market of these efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by such initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors.

Id.

28. *See* Donald C. Langevoort, Essay, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1026 (1990) (discussing the process of collection and analysis of information by investment analysts).

29. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980).

30. *Id*.

expertise and diligence in order to effectively seek out and interpret information.[31] The dissemination of additional market information is incorporated into stock prices, which provides investors with the benefit of buying at a stock price that more closely reflects value.[32]

Analysts collect information from various sources, including public sources,[33] external sources,[34] and, perhaps most importantly, directly from issuers. Direct contacts, such as one-on-one meetings or telephone discussions, allow analysts "to fill out the picture thus far drawn and to facilitate an accurate assessment of information previously generated."[35] Direct contacts also allow analysts to probe into the operations of issuers on a sophisticated level[36] and to fill in the informational gaps of publicly disclosed information.[37]

Additionally, analysts play an important role in verifying information provided by issuers.[38] Analyst recommendations provide credibility to information releases that may otherwise be suspect.[39] Particularly in the case of small issuers,[40] analyst validation stimulates investor interest in corporations that they may otherwise overlook.[41]

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31. *See* SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226, 1230 (S.D.N.Y. 1976), *aff'd* 565 F.2d 8 (2d Cir. 1977) ("Analysts provide a needed service in culling and sifting available data, viewing it in light of their own knowledge of a particular industry and ultimately furnishing a distilled product in the form of reports.").

32. *See* Brountas, *supra* note 2, at 1539 (discussing analysts role in ensuring that information is incorporated into stock prices).

This argument assumes that analysts are actually performing market analysis and providing unbiased recommendations. *See* discussion at *supra* note 90 and accompanying text.

33. *See* Lewis D. Solomon & Dan Wilke, *Securities Professionals and Rule 10b-5: Legal Standards, Industry Practices, Preventative Guidelines and Proposals for Reform*, 43 FORDHAM L. REV. 505, 516 (1975) (listing public sources, including material filed with various public regulatory bodies, press releases, newspapers, and trade publications).

34. *Id*. at 517 (listing external sources, including suppliers, competitors, and market trends that allow an analyst to evaluate an issuer's prospects in relation to the market as a whole).

35. Langevoort, *supra* note 28, at 1026. Corporate attendance at analyst conferences was prevalent and the practice of issuers reviewing analyst reports and making changes or suggestions had become common. *Id*. *See also* Soloman & Wilke, *supra* note 33, at 516.

36. *See* Craft, *supra* note 25, at 127 (noting that selectively disclosed information is too complex for effective use by the vast majority of individual investors).

37. *Id*. at 126. Particularly in the case of small issuers about which there is little publicly available information, direct contact with analysts is crucial in order to provide information to the investment community. For a discussion of the importance of analysts' interstitial role, see *Brountas*, *supra* note 2, at 1539-40.

38. *See* Brountas, *supra* note 2, at 1540 (noting that disclosures to analysts result in an implied warranty of truthfulness when the information eventually enters the market).

39. *Id*. (noting that the corporation's credibility is enhanced when information is communicated through an objective expert).

40. *Id*. at 1541 (noting that information disclosed by small corporations is often received with suspicion).

41. *Id.* at 1542 (stating that analysts serve a vital role in providing voice and credibility to smaller

2. *The Conflict*

The SEC placed issuers and analysts in a difficult situation by encouraging issuers to provide analysts with meaningful immaterial information[42] without disclosing material information, while providing only a vague reasonable person standard of materiality.[43] Under existing case law, information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision.[44] In addition, there must be a substantial likelihood that a fact "would have been viewed by the reasonable investor as having significantly altered the total mix of information made available."[45] This amorphous standard granted the SEC broad discretion in determining which incidents to pursue.

Complicating matters further, the SEC applied the materiality standard unpredictably. For example, in *Bausch & Lomb*,[46] the SEC brought a Rule 10b-5[47] action against Bausch & Lomb and its chairman of the board. The SEC charged the parties with the selective disclosure of material information based on several one-on-one interviews with analysts in which the chairman discussed sales information and the introduction of new

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corporations of which investors are unaware).

42. *See* Solomon & Wilke, *supra* note 33, at 516, n.43 (quoting the SEC statement that "[w]e also recognize that discussions between corporate management and groups of analysts which provide a forum for filling interstices in analysis, for forming a direct impression of the quality of management, or for testing the meaning of public information, may be of value") (quoting Investors Mgmt. Co., Exchange Act Release No. 9267, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,163, at 80,521 (July 29, 1971).

43. *See* SEC v. Bausch & Lomb, 565 F.2d 8, 10 (2d Cir. 1977) (criticizing the SEC for failing to provide additional guidance regarding materiality). *See also* Elkind, *supra* note 29, at 165 ("Whenever managers and analysts meet elsewhere than in public, there is a risk that the analysts will emerge with knowledge of material information which is not publicly available.").

44. *TSC*, *supra* note 5, at 449.

45. *Id*.

46. *Supra* note 43.

47. 17 C.F.R. § 240.10b-5 (2001). Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Id.

products, as well as the probable range for the corporation's quarterly earnings.[48] The SEC contended that the disclosures were per se material due to subsequent price movements in Bausch & Lomb's stock.[49] The Court of Appeals for the Second Circuit rejected the SEC's hindsight materiality approach, holding that subsequent price movements alone did not indicate that the disclosures were material.[50] The court recognized that the current materiality standard placed issuers in a difficult situation when communicating with analysts[51] and criticized the SEC for failing to provide written guidelines for determining materiality.[52]

B. Judicial Balance

Traditionally, the lower courts applied a "disclose or abstain" rule, which imposed insider trading liability on both the issuer and the analyst if the analyst, when gaining material nonpublic information, failed to publicly disclose the information or abstain from trading.[53] This standard created a significant deterrent to selective disclosure, especially in light of the broad interpretation of materiality applied by the SEC.[54]

During the early 1980s, the Supreme Court significantly weakened the SEC's "disclose or abstain" standard[55] and rejected the standard outright in

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48. *Bausch & Lomb*, 565 F.2d at 9-14. The SEC was apparently aware of the issuer's policy of carefully monitoring discussions with analysts and the unusual circumstances surrounding the disclosure in the instance attacked, but insisted that this instance of providing inside information was a violation of Rule 10b-5. *Id*.

49. *Id*. at 15.

50. *Id*. at 15-16 (stating price volatility is not a per se indication that information conveyed was material, especially when other factors were sufficient to induce the fluctuation).

The court further denied injunctive relief pursuant to rule 10b-5 because the SEC had not established that the chairman had acted with scienter and had failed to show a reasonable likelihood of future violations. *Id*. at 18-19. In considering materiality, the court noted that the SEC itself recognized that communications that merely test the meaning of public information are not inappropriate. *Id*. at 14. The court also found it significant that analysts receiving identical information had disparate reactions. *Id*. at 18.

51. *Id*. at 9 (analogizing an interview with a financial analyst to a "fencing match conducted on a tightrope").

52. *See id*. at 10 (stating that "materiality has become one of the most unpredictable and elusive concepts of the federal securities laws," and noting that the SEC's failure to provide written guidelines resulted in an after-the-fact case-by-case approach).

53. *See* Brountas, *supra* note 2, at 1528.

54. *See id*. at 1549 (stating that the liability scheme under rule 10b-5 creates a "considerable disincentive" to selective disclosure).

55. The Supreme Court made the first step in the abandonment of the traditional liability standard in *Chiarella v. United States*, 445 U.S. 222 (1980). In that case, the Court abandoned the "disclose or abstain" rule and established that there could be no violation of Rule 10b-5 unless a fiduciary relationship existed between the issuer and the person trading on the material nonpublic information; mere possession of material nonpublic information was not enough. *See* Brountas, *supra*

the seminal case of *Dirks v. SEC*.[56] In *Dirks*, the SEC censured a security analyst for aiding and abetting violations of Rule 10b-5.[57] The security analyst received material nonpublic information regarding fraudulent corporate practices from a former officer of the issuer, who urged Dirks to verify the fraud and disclose it publicly.[58] While investigating the allegations, which led to public disclosure of the fraud, Dirks discussed the information with clients who sold their stock.[59]

The Court denied Rule 10b-5 liability without deciding whether the information was material.[60] Rejecting the "disclose or abstain" rule that imposed liability on the issuer and the analyst whenever trading occurred on the basis of selectively disclosed material information, the Court formulated a "personal benefit" test that required proof of some advantage to the issuer from the disclosure before an analyst could be liable for insider trading.[61]

The Court specifically noted that imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of the market analyst.[62] The Court endorsed the analyst's ability to "ferret out and analyze information"[63] and stated that not all disclosures of material information are inconsistent with an issuer's fiduciary duties.[64] The Court stated: "In some situations, the insider will act consistently with his fiduciary duty to shareholders, and yet release of the information may affect the market."[65] The Court noted that due to the imprecision of the reasonable person materiality standard, liability for selective disclosure of information must turn on the purpose of the disclosure.[66]

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note 2, at 1529.

56. *Supra* note 8.

57. *Id*. at 650-52.

58. *Id*. at 648-49.

59. *Id*. at 649.

60. *Id*. at 665 & n.25.

61. *Id*. at 667. Under the personal benefit test, analysts who receive material nonpublic information from insiders are liable for insider trading only if the insider breached a fiduciary duty for personal gain and the analyst knew or should have known of the breach. *Id*. at 661-64. As the insiders in this instance disclosed information to reveal fraud, there was no breach of fiduciary duty and, hence, there could be no derivative liability to the analyst. *Id*. at 667.

62. *Id*. at. 658.

63. *Id*.

64. *Id*. at 661-62.

65. *Id*. at 662.

66. *Id*. at 662-63 ("It is important in this type of case to focus on policing insiders and what they do . . . rather than on policing information per se and its possession.") (quoting Investors Mgmt. Co., *supra* note 42, at 80,523 (Smith, Comm'r, concurring)).

The personal benefit test formulated in *Dirks* made it considerably more difficult to prohibit selective disclosure of material information under insider trading law.[67] Some commentators interpreted *Dirks* as creating a "paean to the analyst,"[68] and the market generally believed that issuer communications with analysts held a privileged status.[69] Many commentators interpreted *Dirks* as a Supreme Court endorsement of selective disclosure between an issuer and an analyst in order to protect market efficiency.[70]

C. The Regulation FD Response

Seventeen years after the *Dirks* decision, the SEC renewed its attack on selective disclosure by proposing Regulation FD.[71] Regulation FD, a reporting obligation,[72] provides that whenever an issuer or person acting

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67. *See* Proposing Release, *supra* note 18, at 72,593, in which the SEC stated, "many have viewed *Dirks* as affording considerable protection to insiders who make selective disclosures to analysts, and to the analysts (and their clients) who receive selectively disclosed information."

The SEC however did not accept defeat in *Dirks*. Rather, in *United States v. Stevens*, Litigation Release No. 12813, 48 SEC Docket (CCH) ¶ 739, 1991 SEC LEXIS 451 (Mar. 19, 1991), the SEC attempted to apply a "reputation benefit" standard under the personal benefit test, which would allow enforcement against the issuer if the information was disclosed to enhance the issuers reputation. *Id*. This rule was seen as trivializing the holding in *Dirks*. Coffee, *supra* note 68, at 5. The defendant in *Stevens* settled and the case was never validated in the federal courts. *Id.* However, it sent a clear signal to issuers and analysts that selective disclosure remained precarious activity. *Id*. at 6. For further discussion, *see id.*

68. Brountas, *supra* note 2, at 1529 (citing John C. Coffee, Jr., *The SEC and the Securities Analyst*, N.Y. L.J., May 30, 1991, at 5, 6) (quoting Louis Loss, Fundamentals of Securities Regulation 769 (2d ed. 1988)).

69. *See, e.g.,* Anthony T. Horgan, Comment, *Regulation FD Provides Firm Footing on Selective Disclosure High Wire*, 46 VILL. L. REV. 645, 652 (2001) (noting that after *Dirks*, corporate communications with analysts appeared to enjoy a special status); Daniel J. Kramer, *Speaking to the Market Under SEC's Proposed Rule*, 223 N.Y. L.J., May 12, 2000, at 38 (noting that since *Dirks*, selective disclosure of material nonpublic information by issuers to analysts "has become widely accepted"). *See also* Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1090 (1985) (proposing federal securities law amendment to prohibit any person from trading while in possession of material nonpublic information to address the confusion and enforcement difficulties created by *Dirks*).

70. *See* Clay Richards, Comment, *Selective Disclosure: "A Fencing Match Conducted on a Tightrope" and Regulation FD—the SEC's Latest Attempt to "Electrify the Tightrope,"* 70 MISS. L.J. 417, 439 (2000) (noting the balance *Dirks* created between fairness and efficiency, allowing some market unfairness in order to promote greater market efficiency).

71. Regulation FD, 17 C.F.R. §§ 243.100-243.103 (2001). Some commentators have questioned the SEC's authority to make such a rule. *See* SIA Letter, *supra* note 20 n.6 (stating "we seriously doubt that the Commission has authority to adopt a general requirement that registrants promptly disclose publicly and report to the Commission all material developments or facts relevant to the issuer. We wonder whether it is that much different to impose an obligation to disclose a material development or fact just because it has been disclosed to an outsider.").

72. *See* Final Rule, *supra* note 1, at 51,726 (stating Regulation FD creates duties only under Sections 13(a) and 15(d) of the Exchange Act and Section 30 of the Investment Company Act).

on his behalf discloses material nonpublic information to certain enumerated persons,[73] the issuer must make public disclosure of that same information.[74] If the disclosure is intentional, public disclosure must occur simultaneously;[75] if it is unintentional, the disclosure must occur promptly.[76] The regulation was intended to apply primarily to securities management professionals and individual investors who would be expected to trade on the information at an advantage to the investing public.[77] The SEC provided several exemptions[78] to ensure that ordinary business communications would not be prohibited.[79]

The SEC intended Regulation FD to be enforced only through SEC actions[80] and indicated that private liability for violations of Regulation FD was not available.[81] The SEC explicitly stated that violations of Regulation FD could not provide a basis for private liability under Rule 10b-5;[82] however, concern among issuers remained because violations of Regulation FD provided plaintiff investors with several of the elements of a Rule 10b-5 violation.[83]

73. 17 C.F.R. § 243.100(b)(1). Certain enumerated persons include (1) a broker or dealer, or a person associated with a broker or dealer, (2) an investment adviser, an institutional investment manager, or a person associated with either, (3) an investment company or an affiliated person, and (4) a holder of the issuer's securities who is likely to trade on the basis of the information. *Id*.

74. *Id*. at § 243.100(a). Public disclosure may be effected by furnishing a report under Item 9 of Form 8-K, filing a report under Item 5, or disseminating the information through a method that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public. Final Rule, *supra* note 1, at 51,723. However, a posting of information on an issuer's website is not alone sufficient. *Id.* at 51,724.

75. 17 C.F.R. § 243.100(a)(1).

76. *Id*. at § 243.100(a)(2). "Promptly means as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange)" after a senior official of the issuer knows or is reckless in not knowing that a nonintentional disclosure is both material and nonpublic. *Id*. at § 243.101(d).

77. Final Rule, *supra* note 1, at 51,719.

78. 17 C.F.R. § 243.100(b)(2). Regulation FD shall not apply to disclosures made to the following: (1) a person who owes a duty of trust or confidence to the issuer, (2) a person who expressly agrees to maintain the disclosed information in confidence, (3) an entity whose primary business is the issuance of credit ratings, provided that the information is disclosed solely for the purpose of developing a credit rating and the entity's ratings are publicly available, and (4) in connection with a securities offering. *Id*.

79. Final Rule, *supra* note 1, at 51,720 (noting that persons trading on the basis of ordinary-course business-related communications would likely be liable under the misappropriation theory of insider trading for any misuse of the information).

80. *Id*. at 51,726. SEC enforcement actions could result in a cease-and-desist order, an injunction, or a fine. *Id*.

81. 17 C.F.R. § 243.102.

82. *Id*.

83. *See* ABA Letter, *supra* note 20 ("In practical terms, this provides a roadmap for a prima facie case for a private action claiming violation of the antifraud provisions of the federal securities laws because all of the elements of a violation of Section 10(b) and Rule 10(b)-5 under the Exchange Act

1. *An Emphasis on Fairness*

The SEC premised Regulation FD on fairness considerations, asserting that even if selective disclosure did not violate insider trading laws under the personal benefit test, it unacceptably impaired market fairness.[84] SEC Chairman Arthur Levitt condemned the practice of selective disclosure as a "stain on our markets,"[85] and the final rule pledged to protect investor confidence in the market by combating the "unerodable informational advantages"[86] gained from access to corporate insiders.[87] The SEC cited several highly publicized instances of information leakages to illustrate the need for Regulation FD.[88]

Additionally, the SEC believed Regulation FD would alleviate conflicts of interest between issuers and analysts.[89] The SEC expressed concern that management was pressuring analysts to provide positive analysis in order to continue receiving selectively disclosed information.[90]

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will have been established, except for the elements of a purchase or sale and of reliance, which the courts may presume under the fraud on the market theory.").

In any case, no one wanted to be the first to see exactly how this would work in the courts. For more discussion, see John P. Jennings, Recent Development, *Regulation FD: SEC Reestablishes Enforcement Capabilities Over Selective Disclosure*, 32 ST. MARY'S L.J. 543, 580 (2001) (illustrating how the remedial disclosures required to avoid a violation of Regulation FD may satisfy several elements of a Rule 10b-5 cause of action).

84. Final Rule, *supra* note 1, at 51,716 & n.7. The SEC was particularly concerned with the development of practices such as one-on-one conversations in which analysts were given material information rather than having to analyze nonmaterial information. *Id*.

85. Remarks by Chairman Arthur Levitt, *The Lifeblood of Our Markets*, *at* http://www.niri.org/publications/alerts/levitt101999.cfm (Oct. 18, 1999).

86. Final Rule, *supra* note 1, at 51,716 (citing United States v. O'Hagan, 521 U.S. 642, 658 (1997) (citing Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 356 (1979)).

87. Final Rule, *supra* note 1, at 51,716. The SEC asserted that no amount of research by the general public can substitute for the informational advantages obtained by securities analysts who receive selectively disclosed information. "Investors who see a security's price change dramatically and only later are given access to the information responsible for that move rightly question whether they are on a level playing field." *Id*.

88. *Id*. at 51,717. *See, e.g.*, Susan Pulliam, *Abercrombie & Fitch Ignites Controversy Over Possible Leak of Sluggish Sales Data*, WALL ST. J., Oct. 14, 1999, at C1; *ConAgra Excludes Investors From 3rd-Qtr Earnings Call*, BLOOMBERG NEWS, Mar. 25, 1999; *Goldman Falls After Warning on 2nd-Quarter Profit*, BLOOMBERG NEWS, May 26, 2000, LEXIS; *Pepsi Bottling Gives Select Group Early Look at Data*, BLOOMBERG NEWS, May 15, 2000, LEXIS.

89. Final Rule, *supra* note 1, at 51,716-17.

90. *See id*. at 51,716 (recognizing the potential for management to treat material information as a commodity to be used to gain or maintain favor with particular analysts or investors). *But cf.* Langevoort, *supra* note 28, at 1043 (noting that the market would not provide business to analysts who consistently gave biased advice).

While Regulation FD attempted to reduce analyst bias by eliminating selective disclosure, many commentators have noted that biased analyst recommendations reflect broader structural problems in the investment banking industry. For a discussion of analyst conflicts of interest identified by the SEC, The SEC anticipated Regulation FD would lead to more objective analysis and to more accurate recommendations from analysts.[91]

Finally, the SEC intended Regulation FD to promote broader dissemination of information.[92] The SEC stated that due to technological advancements that granted the investing public access to unprecedented levels of information, investors no longer needed analysts to act as information intermediaries.[93] The SEC intended Regulation FD to encourage real time communications directly to the investing public.[94]

2. *Response to Regulation FD*

The Proposing Release[95] of Regulation FD generated enormous public comment.[96] Regulation FD received overwhelming acceptance from the investing public, and many commenters expressed surprise that existing law did not already prohibit this practice.[97] However, other commenters, including issuers, securities industry participants, and professional and trade associations, criticized Regulation FD as an inappropriate response to selective disclosure.[98] Although almost all of these commenters agreed

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see Lori Richards, *Analysts Conflicts of Interest: Taking Steps to Remove Bias*, *at* http://www.sec.gov/news/speech/spch559.htm (May 8, 2002). *See also* Sarbanes-Oxley Act of 2002, H.R. 3763, 107th Cong. § 501 (2002) (requiring the SEC to adopt rules to address securities analysts' conflicts of interest by July 29, 2003).

91. Final Rule, *supra* note 1, at 51,717.

92. *Id*.

93. *Id*. ("[T]echnological limitations no longer provide an excuse for abiding the threats to market integrity that selective disclosure represents.").

However, the SEC ignored that, despite technological advances, the investing public continues to rely on securities professionals for their investment decisions. According to the SIA Survey, *infra* note 99, 46% of surveyed investors depend on professional advisors for investment decisions.

94. *Id*. The SEC pointed out that issuers can broadly disseminate information directly to the market through Internet webcasting and teleconferencing. *Id*.

95. *Supra* note 18.

96. *See* Final Rule, *supra* note 1, at 51,717 (stating that the Proposing Release generated nearly 6,000 comment letters from the public, the majority from individual investors). *See also*, Merritt B. Fox, *Regulation FD and Foreign Issuers: Globalization's Strains and Opportunities*, 41 VA. J. INT'L L. 653, 654 (2001) ("Regulation FD is arguably the most important change to the U.S. disclosure regime since the adoption of integrated disclosure almost two decades ago.").

97. Final Rule, *supra* note 1, at 51,718. However, these commenters most likely represent a sophisticated subset of the investing public. *See* SEC Commissioner Laura S. Unger, *Rethinking Disclosure in the Information Age: Can there Be Too Much of a Good Thing?*, *at* http://www.sec.gov/news/speech/spch387.htm (June 26, 2000) (noting that over 5,000 of the comments from the investing public were received through e-mail, indicating the response was from an Internet savvy group) [hereinafter Unger, *Rethinking Disclosure*]; Editorial Staff, *Most Individual Investors Haven't Heard of Reg. FD*, Investor Relations Business, Nov. 6, 2000 (citing a Paine Webber Group survey of 1,007 randomly selected individual investors, finding that as many as 84% of participants had not heard of Regulation FD and only 55% were in favor of the new rule when it was explained to them).

98. Final Rule, *supra* note 1, at 51,717-18. *See, e.g.*, SIA Letter, *supra* note 20 ("Given the recent

that selective disclosure of material nonpublic information was unacceptable,[99] some claimed that the incidents of selective disclosure prompting Regulation FD amounted to highly publicized, rare occurrences that did not reflect the reality of the marketplace.[100]

In addition, commenters expressed concern that the SEC implemented Regulation FD at an inopportune time, when the market was already responding on its own.[101] When Regulation FD was released, many significant improvements had already made in the dissemination of material information to the public.[102] However, the SEC dismissed appeals to encourage broader dissemination of information through guidance, rather than rulemaking.[103]

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trends toward more open disclosure and the relatively small number of instances of inappropriate selective disclosure, we find it very puzzling and troubling that the Commission is considering a step that we believe will operate to constrict the flow of information.").

99. Final Rule, *supra* note 1, at 51,717. *See, e.g.*, ABA Letter, *supra* note 20 ("We do not countenance selective disclosure that seeks to provide an informational advantage to selected market participants, and we regularly counsel our clients to refrain from engaging in selective disclosure and to publicly disseminate material information that may have been selectively disclosed."). *See also* NIRI, Standards of Practice for Investor Relations (Apr. 1998) at 27-37 (containing recommendations on how to avoid selective disclosure before the enactment of Regulation FD); Securities Industry Association, *Costs and Benefits of Regulation Fair Disclosure* (May 17, 2001), *at* http://www.sia.com/reg-fd/pdf/RegFD.pdf ("We favor a system that provides broad, non-discriminatory dissemination of quality information.") [hereinafter SIA Survey].

100. *See, e.g.*, ABA Letter, *supra* note 20 (noting that the SEC provided primarily anecdotal evidence of selective disclosure, without reference to any "relevant economic or similar study evaluating . . . the breadth and market impact of selective disclosure activity").

101. *See, e.g.*, Letter from American Society of Corporate Secretaries, *available at* http://www.sec.gov/rules/proposed/s73199/foran1.htm (Apr. 28, 2000) ("Given the rate of technological changes and the ability to get information out to the population at large, the general impression is that more universal disclosure is generally improving with issuers. We think this trend will continue without [Regulation FD]."); ABA Letter, *supra* note 20 ("[P]ublic companies, on their own initiative, are eliminating many of the problems of selective disclosure that apparently motivated the Commission to propose Regulation FD and are broadly disseminating information at an accelerating pace.").

102. *See, e.g.*, NIRI Executive Alert, *Most Conference Calls Are Now Open to Individual Investors and the Media* (Feb. 29, 2000), *at* http://www.niri.org/publications/alerts/e9022900.cfm (discussing a survey of 225 public companies that found that nearly half of issuers who conducted analyst conference calls were broadcasting them live over the Internet and seventy-four percent permitted the media access to these calls); Association for Investment Management and Research, *Financial Analysts Rate Conference Calls Best Source of Earnings Information in AIMR Survey*, *at* http://www.aimr.org/infocentral /news/99releases/int-study.html (Feb. 16, 1999).

103. Many commenters believed that guidance promoting voluntary adherence to best practices would be more appropriate than rulemaking, based on recent improvements in issuer disclosures. *See, e.g.*, ABA Letter, *supra* note 20 (urging the SEC to address selective disclosure through interpretive releases and private initiatives); Letter from American Society of Corporate Secretaries, *supra* note 101 (requesting concrete examples of materiality contrasting with examples of close, but less than material, selective disclosure).

3. *Materiality Standard*

During the comment period for the proposed Regulation FD, commenters most frequently criticized the vague materiality standard, claiming that it would "chill" the flow of information in the market.[104] Commenters claimed that a clearer standard was necessary to avoid harmful side effects to market efficiency.[105]

Regulation FD adopts the traditional definition of materiality developed in existing case law,[106] which the SEC supplemented with references to other materiality standards.[107] Although the SEC reassured commenters that it would not go after borderline cases,[108] it also provided that issuers could not avoid a violation by breaking down material information into ostensibly immaterial pieces.[109]

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104. Final Rule, *supra* note 1, at 51,721. The use of the materiality standard in Regulation FD was the subject of many comments. *Id*. *See, e.g.*, ABA Letter, *supra* note 20 ("[W]e are concerned that the rulemaking approach adopted by the Commission . . . could have a pervasive impact on corporate information practices and runs a significant risk of chilling the accelerated pace of information flow to the markets."). *But cf.*, Letter from North American Securities Administrators Association to the Securities and Exchange Commission, at http://www.sec.gov/rules/proposed/s73199/skolnik1.htm (Apr. 28, 2000) ("[T]he proposed rule strikes the right balance between fostering the continuous flow of information to the marketplace and fair and full disclosure to all investors.").

105. *See, e.g.*, ABA Letter, *supra* note 20 (proposing an exclusive list identifying information that the SEC considers material or, alternatively, a materiality standard specific to Regulation FD). However, other commentators noted that attempts to provide a definition of materiality specific to Regulation FD could have implications on other areas of securities laws. *See, e.g.*, Letters of North American Securities Administrators Association, *supra* note 104 (expressing concern that an attempt to define materiality for purposes of Regulation FD could have broader implications).

106. Final Rule, *supra* note 1, at 51,721. *See supra* note 5 and accompanying text.

107. *Id*. at 51,721 & n.38 (referencing Staff Accounting Bulletin No. 99 ("SAB 99"), 64 Fed. Reg. 45,150 (Aug. 12, 1999) (to be codified at 17 C.F.R. pt.211), which provides a materiality standard for purposes of financial statements). SAB 99 stands for the proposition that if a disclosure had a significant impact on trading in hindsight, it could be considered material. *Id*. at 45,152. Commentators have noted that inclusion of this standard is confusing and unclear. *See, e.g.*, *Unger Report Pinpoints Materiality: Reg. FD Study Shows Plenty of Room for Improvement*, INVESTOR RELATIONS BUSINESS, Jan. 14, 2002 (stating that the SEC should clarify the interplay between Regulation FD and SAB 99 to alleviate concerns about hindsight materiality).

108. Final Rule, *supra* note 1, at 51,722 ("[I]ssuers need not fear being second guessed by the Commission in enforcement actions for mistaken judgments about materiality in close cases."). However, the Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association, in their letter to the SEC, argued that indications that the SEC will exercise conservative prosecutorial judgment would make enforcements actions unpredictable. "Regulation premised on less than careful compliance is not sound policy because it runs the risk of (i) eroding the self-policing aspect of our securities regulatory system which is an important foundation of our market's integrity or (ii) resulting in uneven and inconsistent compliance." ABA Letter, *supra* note 20.

109. Final Rule, *supra* note 1, at 51,721. Regulation FD will not be implicated where an issuer discloses immaterial information whose significance is discerned by the analyst. *Id*. at 51,722. However, an issuer cannot render material information immaterial by breaking it into ostensibly non-material pieces. *Id*. at 51,721.

The SEC refused to clarify the standard of materiality, stating that flexibility was required to respond to the circumstances of each case.[110] The SEC provided examples of what could be considered material[111] but indicated that the list of examples was not exhaustive.[112] The SEC stated that it would be necessary to look at all the facts and circumstances surrounding the disclosure[113] and indicated that earnings guidance would receive enhanced scrutiny.[114]

Recognizing the consternation that the materiality standard created, the SEC offered some tips for complying with Regulation FD.[115] However, commenters generally viewed the tips as largely impracticable and unworkable.[116]

III. ANALYSIS

Regulation FD commendably encourages the broad dissemination of material information; however, by failing to define materiality, it

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110. *Id.* "[W]e do not believe an appropriate answer to this difficulty is to set forth a bright-line test, or an exclusive list of "material" items for purposes of Regulation FD." *Id*.

111. *Id*. While declining to provide an exhaustive list, the SEC provided a list of items of information or events that should be "reviewed carefully" in determining materiality: (1) Earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers; (4) changes in control or in management; (5) change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report; (6) events regarding the issuer's securities; and (7) bankruptcies or receiverships. *Id*. The SEC noted that some of these items are currently covered in Form 8-K reporting requirements. *Id*. at 51,721 n.47. The SEC also referenced NASD rules, suggesting that at least some of these items were already prohibited from selective disclosure under self-regulatory rules. *Id*.

112. *Id*. at 51,721. The SEC added that the items on the list were not per se material, "although some determinations will be reached more easily than others." *Id.*

113. *Id*. ("A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress' policy decisions.") (quoting Basic Inc. v. Levinson, 485 U.S. at 236).

114. *See id*. (suggesting that issuers should avoid any prospective disclosure regarding earnings).

115. *Id*. at 51,721 n.44. The SEC encouraged issuers to designate a limited number of persons who are authorized to make a disclosure or field inquiries from securities professionals; encouraged issuers to keep a record of communications with analysts; decline to answer sensitive questions until issuer personnel could consult with counsel; and seek time-limited confidentiality agreements from analysts. *Id*.

Some commentators suggested that the SEC create a safe harbor for firms that have strong policies in place to monitor disclosure, but the SEC declined. *Id. See, e.g.*, Letter from the American Society of Corporate Secretaries, *supra* note 101.

116. Final Rule, *supra* note 1, at 51,721 n.44. For example, the suggestion to decline to answer sensitive questions until issuer personnel could consult with counsel was impracticable because real time questions do not provide time to consult with counsel. Furthermore, counsel was generally equally unsure of what could be disclosed. In response to these concerns, the SEC stated, "[w]e did not intend to suggest that issuers were required to implement any of these practices, but only offered them as suggestions." *Id.*

unacceptably restricts the flow of immaterial information.[117] The inability of issuers to differentiate between material and immaterial information prompted the Supreme Court in *Dirks* to allow some selective disclosure of material information through issuer and analyst communications in order to protect market efficiency.[118] In adopting Regulation FD, the SEC promoted market fairness without responding to the risks to market efficiency envisioned in *Dirks*.[119]

A. The Murky Materiality Standard

Since the adoption of Regulation FD, commentators most frequently criticize the vague materiality standard.[120] The subjective reasonable person standard potentially encompasses any information that produces a market reaction.[121] "In fact, in something of a Catch 22, from the mere fact that a knowledgeable and experienced analyst asks a question, it could be argued that a reasonable investor would consider the answer important in making an investment decision."[122]

Although the reasonable person materiality standard functioned for many years in the context of insider trading law, it fails in the area of selective disclosure due to the need for real time materiality judgments.[123] When issuers engage in "rapid real time communications" with analysts, they must make "snap materiality judgments under often probing, difficult

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117. *See* ABA Report, *supra* note 22 (noting that the uncertainties inherent in the materiality standard "create a tension between issuers and analysts that makes operation of the mosaic theory difficult").

118. *See supra* note 70 and accompanying text. *See also* Brountas, *supra* note 2, at 1549 ("The goal of securities regulation should not be to provide a "level playing field," but to curb fraud while encouraging the search for and dissemination of information.").

119. *See* Richards, *supra* note 70, at 439 (noting that Regulation FD could potentially eliminate the balance between efficiency and fairness created in *Dirks*). *But cf.* Horgan, *supra* note 69, at 667 (predicting that Regulation FD will result in a more efficient market due to significant decreases in acquisition and verification costs).

120. *See* ABA Report, *supra* note 22 ("Materiality is the greatest point of stress under Regulation FD."). *See also* Craft, *supra* note 25 ("One of the largest failures of Regulation FD is the SEC's lack of any meaningful guidance or direction as to what information will and will not be considered material.").

121. *See* ABA Letter, *supra* note 20 (stating that market reactions may reflect an unanticipated assessment of materiality, even after careful consideration of materiality by issuers); SIA Letter, *supra* note 20 ("In all the information authorized employees communicate to outsiders every day, or even to security analysts, it may be very hard to say what would not be considered 'important' by a reasonable shareholder in making an investment decision.").

122. SIA Letter, *supra* note 20.

123. *See* ABA Letter, *supra* note 20 (stating the materiality decisions in the context of Regulation FD differ from the context of preparing a registration statement or periodic report).

circumstances."[124] Regulation FD chills spontaneous communications between issuers and analysts because issuers are necessarily more cautious and feel compelled to consult counsel more frequently.[125]

In addition to the concerns raised regarding the reasonable person standard, the SEC's reference to Staff Accounting Bulletin No. 99 ("SAB 99") further complicates the materiality standard in Regulation FD.[126] Although members of the SEC Staff have indicated that SAB 99 codifies only existing principles and case law,[127] many issuers and practitioners believe that SAB 99 establishes a lower threshold of materiality.[128] In particular, SAB 99 subjects disclosures to hindsight assessments, based on the market's response to a disclosure.[129] As a result, issuers may be reluctant to disclose immaterial information out of fear that such information will have an effect on the market.[130]

Rather than providing additional interpretive guidance about the types of information likely to be material, the SEC provided seven categories of information that the SEC indicated would likely be considered material.[131] Issuers, however, generally considered these items too broad to provide any real guidance.[132] Furthermore, the SEC did not intend the list to be exhaustive;[133] issuers still must apply good judgment in situations not addressed in the list.[134] As a result, the items, in effect, merely refer the

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124. *Id*.

125. *See* Letter from Cleary, Gottlieb, Steen & Hamilton to Securities Exchange Commission *at* http://www.sec.ov/rules/proposed/s73199/cleary1.htm (Apr. 28, 2000) (noting that the result would be "less of the spontaneous candid disclosure that is not found in more formal disclosure documents such as press releases and Form 8-K filings"). For example, an issuer may wish to avoid dialogue with analysts and investors, or to suspend dialogue in order to confer with counsel. *Id*.

126. *See supra* note 107 and accompanying text. For further discussion on SAB 99, see Glenn F. Miller, Comment, *Staff Accounting Bulletin No. 99: Another Ill-Advised Foray into the Murky World of Qualitative Materiality*, 95 NW. U. L. REV. 361 (2000).

127. ABA Report, *supra* note 22.

128. *See* ABA Letter, *supra* note 20 (stating that the breadth of SAB 99 "will make materiality judgments required by Regulation FD more difficult and will expose companies to after-the-fact assessments of their materiality judgments").

129. *See* ABA Report, *supra* note 22. Market reaction is a key factor of materiality under SAB 99, which can only be determined with the benefit of hindsight. *Id*.

130. *Id*. ("It may be too delicate an endeavor in light of SAB 99 to discern whether information is not material and is yet significant to an analyst's understanding of a company."). For example, an issuer may disclose information that it believes, after careful consideration, is not material. However, if the information allows an analyst to make a material inference based on information the analyst obtained from other sources, the disclosure may have a material price on market price and violate Regulation FD. *See supra* note 121.

131. *See supra* note 111.

132. "[T]he seven categories have provided more confusion than clarity about what materiality means under the Reg FD regime." Unger Report, *infra* note 137.

133. Final Rule, *supra* note 1, at 51,721.

134. *See* Richard H. Walker, Director, Division of Enforcement, SEC, Remarks before the

issuer back to the reasonable person standard.[135]

In addition, the SEC stated that disclosures regarding earnings guidance are almost always material.[136] However, the SEC failed to clarify earnings guidance,[137] despite the fact that almost all disclosures relate to earnings in some manner.[138] Furthermore, the SEC failed to indicate when issuers can confirm prior public guidance to an analyst without being liable for the selective disclosure of new information.[139]

B. *Market Efficiency: Realizing the Warnings of* Dirks

In adopting Regulation FD, the SEC made explicit that it did not intend to limit the collection of immaterial information.[140] However, the vague standard of materiality applied in Regulation FD potentially makes it too difficult for issuers to determine what is immaterial.[141] As a result, Regulation FD restricts an analyst's ability to "ferret out"[142] immaterial information from an issuer or question information provided by the issuer. For example, before Regulation FD, issuers commonly allowed analysts to ask questions and seek explanations.[143] As a result, analysts were able to discover new information and challenge information provided in order to

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Compliance and Legal Division of the Securities Industry Association, *at* http://www.sec.gov/news/speech/spch415.htm (Nov. 1, 2000).

135. *See* Craft, *supra* note 25, at 156 (stating that the list of items "do little more than refer the issuer to the already murky case law on the issue of materiality").

136. Final Rule, *supra* note 1, at 51,721 ("When an issuer official engages in a private discussion with an analyst who is seeking guidance about earnings estimates, he or she takes on a high degree of risk under Regulation FD. If the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated earnings will be higher than, lower than, or even the same as what the analysts have been forecasting, the issuer likely will have violated Regulation FD.").

137. According to a report prepared by SEC Commissioner Laura Unger examing Regulation FD one year after its effective date, it is unclear what information falls under the rubric of earnings information. Commissioner Unger recommended that the SEC should clarify "earnings information" by indicating if certain income items are more likely to be deemed material than others. *See* Commissioner Laura S. Unger, *Special Study: Regulation Fair Disclosure Revisited* (Dec. 6, 2001), *at* http://www.sec.gov/news/studies/regfdstudy.htm [hereinafter Unger Report].

138. Craft, *supra* note 25, at 155 (stating that practically any information disclosed could have some attenuated relation to earnings).

139. *Id*. (noting that the SEC has not clarified relevant factors for determining when it is appropriate to confirm prior guidance).

140. *See* Final Rule, *supra* note 1, at 51,722 (stating that analysts "provide a valuable service in sifting through and extracting information that would not be significant to the ordinary investor" and that "[w]e do not intend, by Regulation FD, to discourage this sort of activity").

141. *See Dirks*, *supra* note 8, at 658 n.17 (labeling the case law materiality standard used in Regulation FD as "inherently imprecise").

142. *See supra* note 63 and accompanying text.

143. *See supra* note 35 and accompanying text.

evaluate a company.[144] However, under Regulation FD, issuers are more likely to avoid informal communications altogether.[145]

The broad materiality standard also prohibits issuers from selectively disclosing information to analysts that cannot be disseminated to the public for various reasons.[146] For example, before Regulation FD, issuers had an incentive to selectively disclose long-term sales projections to an analyst in order to disseminate the information without risking legal exposure.[147] As a result, the market price would more accurately reflect business prospects without creating legal risks.[148] However, under Regulation FD, the broad standard of materiality makes it unclear what information issuers can selectively provide to analysts. Rather than risk violation of Regulation FD, the rule encourages issuers to withhold information that cannot be provided to the public at large.

C. Effects of Regulation FD

Since the adoption of Regulation FD, numerous industry and other groups have performed studies to assess Regulation FD's impact on the market.[149] In addition, the SEC convened a roundtable discussion six months after the rule's effective date to monitor the impact of Regulation

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144. *See* SIA Survey, *infra* note 99. Informal communications were particularly important in the case of small issuers, who often cannot bear the expense of frequent public disclosures. For a discussion of Regulation FD's potential disparate impact on small issuers, see Craft, *supra* note 25, at 157.

145. *See, e.g.*, Rayne Wolfe, *Fair Disclosure Rule Puts Businesses on Edge Fear of Improperly Divulging Financial Information Stifles Many*, THE PRESS DEMOCRAT, Nov. 19, 2000 (noting company chose to skip investment conferences rather than risk disclosing inappropriate information) [hereinafter Wolfe, *Fair Disclosure*]. *See also* SIA Survey, *infra* note 149 (stating that although Regulation FD encouraged more fundamental analysis, no amount of analysis compensates for lack of discussion with management).

146. *See* Langevoort, *supra* note 28, at 1028-29. Issuers prefer informal contacts with analysts as a means of providing information for several reasons. First, for competitive reasons the issuer may wish to disclose information in substance while withholding the details. *Id*. at 1029. Second, the issuer may fear liability for publicly disclosing speculative information about the company's prospects. *Id.* Third, the issuer may wish to bond the accuracy of the information. *Id*. at 1030. Finally, the issuer may believe that it can gain more analyst coverage if it provides an analyst with exclusive access. *Id*. at 1030-31.

147. *Id*. at 1029.

148. *Id*. at 1029 & n.24.

149. *See* SIA Survery, *supra* note 99 (summarizing the results of the SIA's interviews with 30 buy and sell side analysts, the National Investors Relations Institute's (NIRI) survey of 577 issuing companies, and the Association for Investment Management and Research's (AIMR) survey of 423 buy and sell side analysts); Unger Report, *supra* note 137 (summarizing eight FD-related studies performed by Thomson Financial, the NIRI, the AIMR, the American Bar Association, PriceWaterhouseCoopers, and the SIA); ABA Report, *supra* note 22 (summarizing the results of various studies performed on the effects of Regulation FD).

FD.[150] These studies generated different information regarding the effects of Regulation FD, generally reflecting the different perspectives of the constituencies responding.[151] However, these studies provide a useful starting point for identifying areas of concern.

1. *Quantity of Information*

Although most studies indicated that Regulation FD provides market participants relatively equal access to information,[152] the responses varied as to whether Regulation FD restricts the amount of information available. Issuers generally claimed that the same amount or more information was being provided,[153] reporting continued face-to-face meetings with analysts.[154] In contrast, analysts and portfolio managers generally believed that Regulation FD chilled issuer communications.[155] According to a Securities Industry Association study,[156] many issuers have curtailed communications with analysts, providing fewer one-on-one discussions and replacing free dialogue in such meetings with scripted statements and references to already public material.[157]

Any restriction on information means that even if all investors receive information at the same time, issuers are providing less information overall.[158] As information is crucial for properly valuing securities[159] and

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150. *See* Unger Report, *supra* note 137 (summarizing the discussion at the roundtable).

151. *See* ABA Report, *supra* note 22.

152. *See* Unger Report, *supra* note 137 (summarizing the results of various studies performed on the effects of Regulation FD).

153. *Id*. (citing a wire service that claimed the number of earnings guidance releases increased more than tenfold and webcast announcements nearly quadrupled since the enactment of Regulation FD).

154. *Id*. (citing NIRI study finding that 80% of issuers continued to hold one-on-one meetings after the enactment of Regulation FD).

155. *Id*. (citing ABA survey reporting that securities attorneys claimed that the number of their clients providing one-on-one meetings dropped from 77% to 27% after the enactment of Regulation FD; AIMR study finding that 69% of buy-side and 70% of sell-side analysts reported fewer one-on-one meeting after the enactment of Regulation FD).

156. SIA Survey, *supra* note 99.

157. *See, e.g.*, Unger Report, *supra* note 137 (citing an analyst who claims that issuers are no longer willing to complete paper questionnaires requesting general background information due to Regulation FD); Lee Clifford, *The SEC Wants to Open the Info Vault: Regulation FD Sounds Great on Paper, but Will It Help Investors Know More About the Companies They Own?*, FORTUNE MAGAZINE, Nov. 13, 2000, at 434 (noting that guidance through one-on-one meetings with analysts is "history"); *Get Ready for the Regulation FD Shakedown Cruise*, PHILLIPS BUSINESS INFORMATION, INC., Sept. 11, 2000 (noting that reviewing analysts' drafts, holding one-on-one meetings with analysts, and attending analysts' conferences are three major areas of risk that issuers should avoid). *But cf.*, *id.* ("[T]his period with a lot of gray area . . . does give investor and corporate communications professionals a chance to redefine it.").

158. *See* Clifford, *supra* note 157 ("It's great to be on a par with Goldman and Fidelity, but not if

ensuring an efficient market,[160] less information in the market is a significant concern. In the final analysis, it appears that Regulation FD makes it much easier for issuers to withhold information from the public.[161]

2. *Quality of Information*

Studies performed since the adoption of Regulation FD suggest that issuers provide less valuable information under Regulation FD. Although some issuers reported providing information of the same or better quality,[162] other issuer studies reported instances of lower quality information.[163] Analysts generally reported deterioration in the quality of written and oral issuer communications, indicating that many issuers responded to Regulation FD by replacing explanations with boilerplate language.[164]

By requiring broad public disclosure of information that may be deemed material, Regulation FD encourages issuers to disseminate raw data independent of context and analysis; however, providing equal access to raw data is useful only to those with the expertise and time to analyze it.[165] Even if the public is able to effectively use such information, no

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you're all getting blindsided together.").

159. *See, e.g.*, Holman W. Jenkins, Jr., *Smart Investors Let Others Do the Work*, WALL ST. J., Aug. 16, 2000, at A23 ("[T]he value of information to the small investor is that it becomes incorporated in a company's stock price, signalling to senior management the market's best collective judgment on a company's plans for generating a long-run return.").

A properly valued security is priced based on all available information. Some commentators have suggested that the risk of selective disclosure is included in the price paid by the investor; as this is a beta risk that can be wholly diversified away, it should not be such a large concern. For further discussion, see Fox, *supra* note 96, at 672 & n.61.

160. For more discussion, see Fox, *supra* note 96, at 674-75.

161. *See* Craft, *supra* note 25, at 158. "[I]t does not necessarily follow that, just because the SEC has made it more difficult for the issuer to communicate with the analyst, the issuer will choose to provide the same amount of information to the public." *Id.*

162. *See* Unger Report, *supra* note 137 (citing ABA survey reporting that securities attorneys claimed that 50% of their clients provide the same quality of information and 30.6% of their clients provide better quality information after the enactment of Regulation FD).

163. *Id.* (citing NIRI survey finding that the percentage of issuers willing to review analyst earning models has declined from 81% to 53%; Thomson Financial survey finding that 29.4% have less frequent contact with analysts and investors).

164. *Id.* (citing SIA survey finding that 72% of analysts feel that information communicated by issuers to the public is of low quality after the enactment of Regulation FD; AIMR survey stating that 62% of analysts report candor has deteriorated after the enactment of Regulation FD).

165. *See* SIA Survey, *supra* note 99. *See* Unger, *Rethinking Disclosure*, *supra* note 97 ("[W]e have to remember that information can only empower investors if they understand it and can effectively apply it."). Many investors are incapable of making sound investment decisions on the basis of raw, unanalyzed information. *See, e.g.*, Wolfe, *Fair Disclosure*, *supra* note 145 (citing a

amount of independent investigation can compensate for discussion with senior management in the case of large or new companies with complex or technical business models. Furthermore, Regulation FD renders analysts unable to even challenge information provided by issuers in an attempt to validate the information provided.[166]

Additionally, the elusive standard of materiality leaves issuers unsure of what information can still be provided to analysts. General counsel tends to provide overly cautious advice in order to avoid the gray area.[167] Despite SEC assurances that issuers need not fear being second-guessed by the Commission in enforcement actions for mistaken judgments about materiality in close cases,[168] issuers have generally taken an extremely cautious stance, unwilling to put these assurances to the test.[169]

IV. PROPOSAL: REDUCING THE CHILLING IMPACT OF REGULATION FD

A. *Limit the Materiality Standard to Specified Information*

The SEC should provide a definition of materiality in Regulation FD that limits material information or events to listed occurrences, creating a rebuttable presumption that disclosure of any such item is a violation.[170]

February 1997 survey conducted by the National Association of Securities Dealers that found that while 60% of Americans know the difference between a halfback and a quarterback, only 14% know the difference between a growth stock and an income stock).

166. *See* Paul A. Ferrillio, *Reexamining Corporate Disclosure Practices*, CORPORATE COUNSELOR, Nov. 2000 (noting analysts generally may not demand follow-up questions to information contained in a release during one-on-one meeting without violating Regulation FD).

167. *See, e.g.*, Lisa I. Fried, *Selective Disclosure: Proposed SEC Regulation Raises Compliance Issues*, 223 N.Y. L.J., Mar. 16, 2000, at 5 (noting that counsel will be forced to guess what impact company information will have on a volatile market).

168. *See supra* note 108.

169. *See, e.g.*, Wolfe, *supra* note 145 ("I'm keeping a detailed log—everyone I talk to—and I make a notation every time I have to say, 'Sorry, that question[s] [sic.] is over the line.'" (quoting Jeff Finn, director of investment relations for Advanced Fibre Communications)).

170. The SEC should amend Regulation FD to limit material information to the enumerated events that are currently "reviewed carefully," see *supra* note 111, to Regulation FD should include the following definition of materiality:

> Material. A selective disclosure of information will be presumed to be material if it pertains to any of the following events: (1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers; (4) changes in control or in management; (5) changes in auditors or auditor notification that issuer may no longer rely on an auditor's audit report; (6) events regarding the issuer's securities; and (7) bankruptcies or receiverships.
>
> The Defendant shall bear the burden of rebutting any such presumption by proof that the event in question was not in actuality material.

Currently, the SEC fails to define materiality in Regulation FD, adopting the standard developed in case law and listing some types of information or events that will be "reviewed carefully."[171] However, the uncertainty inherent in this definition unacceptably restricts an analyst's ability to get immaterial information.

By providing a definition, the SEC could prohibit material announcements to private audiences without prohibiting the analyst from performing his traditional role of questioning management. Providing a bright-line definition would also reduce the chilling effect Regulation FD has on the quantity and quality of information by allowing issuers to structure their communications in accordance with Regulation FD without incurring liability. In addition, a bright-line definition would reduce the legal costs expended by issuers in order to receive guidance on what can be disclosed. The largest Regulation FD-related expense for issuers has been identified as the legal work involved in the determination of the materiality of information.[172]

Some commentators have expressed concern that a new definition of materiality for Regulation FD may create confusion in other areas of securities law.[173] However, as Regulation FD is a reporting requirement that was created to respond directly to selective disclosure, this concern is not justified. Because issuer and analyst communications require continuous real time judgments regarding materiality, Regulation FD should not subject the practice of selective disclosure to the broad definition of materiality developed in anti-fraud case law.

The SEC opposes a bright-line test because it believes that any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality necessarily must be over- or under-inclusive.[174] In the case of Regulation FD, however, a narrower standard of materiality could effectively protect investor confidence in the market. A bright-line test would ensure investors that issuer-analyst communications were greatly curtailed, without impairing the ability of the analyst to provide sound

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171. Final Rule, *supra* note 1, at 51,721.

172. SIA Survey, *supra* note 99.

173. Some commentators have noted that creating a new definition of materiality for Regulation FD may create confusion in other areas of securities law. *See supra* note 105. However, these fears are misplaced. *See* discussion *supra* Part IV.A.

174. Final Rule, *supra* note 1, at 51,721 (citing *Basic*, 485 U.S. at 236).

recommendations. In fact, as investors rely on security analysts for investment decisions,[175] without a clearer definition of materiality Regulation FD has the ironic effect of limiting the flow of valuable information available to the investing public.[176]

B. Clarify the Materiality Standard with Additional Examples

If the SEC is unwilling to create an exclusive list of events that would be material, it should at least provide more guidance on materiality. More guidance should come in the form of an interpretive release issued by the SEC to make its position on materiality clearer.[177] For example, the SEC should provide situational examples of both acceptable and prohibited issuer disclosures. In addition, the SEC should clarify the interplay between Regulation FD and SAB 99, allowing issuers to know what impact the SEC intends subsequent stock price movements to have on materiality.[178] This guidance would provide issuers the necessary reassurance that disclosures of immaterial information are not actionable.

Although the SEC may be concerned that any additional guidance will restrict its ability to apply Regulation FD to the facts and circumstances of each case, failure to provide such guidance weakens the effectiveness of Regulation FD by making enforcement actions unpredictable. Regulation FD represents a hard-line approach to selective disclosure, despite the SEC's respect for the role of analysts.[179] Issuers and analysts deserve the opportunity to structure their transactions in accordance with SEC guidance rather than on reliance on SEC statements that Regulation FD is not meant to entrap and will be applied loosely.[180]

V. CONCLUSION

The SEC continues to endorse the role of the analyst as necessary for the preservation of a healthy market. However, as demonstrated by the enactment of Regulation FD, the SEC fails to recognize that a vague materiality standard inhibits material and immaterial disclosures alike. A

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175. *See supra* note 93.

176. *See* SIA Survey, *supra* note 99 (finding that the 88 million owners of equity mutual funds will be disadvantaged to the extent that brokers and fund managers rely on research and recommendations produced by analysts).

177. *See* Unger Report, *supra* note 137.

178. *Id.*

179. *See supra* note 140.

180. *See supra* note 108.

clear definition of materiality would allow Regulation FD to protect market integrity without restricting the analysts' ability to obtain the information necessary to complete the mosaic.

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