ROAD SHOWS AND ANALYSTS

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I. Road shows

1. Introduction - road show defined

A central part of the marketing process in a securities offering is the road show. Road shows are organized by the lead underwriters to develop the interest of investors in a specific offering of securities. They also help develop long-term investor interest in an issuer[1].

Typically, road shows consist of a series of meetings in the U.S. or the U.S. and abroad, which range from a couple of days to several weeks, during which the issuer's management meets with institutional investors, securities sales personnel, analysts and money managers. A road show presentation usually begins with an introduction by the lead underwriter followed by a well rehearsed management presentation. Afterward, the audience is given the opportunity to ask questions. The presentation is usually accompanied by slides, graphs and other visual aids. Each meeting lasts about two hours, usually over the course of a breakfast or lunch[2].

2. Background - development of the road show as we know it today

Originally, road shows were intended as meetings between potential underwriting syndicates and selling group members and the issuer and lead underwriters. Designed to help the syndicate and selling group members evaluate whether they wanted to participate in an offering as well as help satisfy the "due diligence" defense to potential liability provided by

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[1] Linda C. Quinn & Ottilie L. Jarmel, The Road Less Traveled: The Advent of Electronic Roadshows, Insights, Volume 11, Number 7, at 3, July 1997.

[2] Stephen J. Schulte, IPO Road Shows Today: A Primer for the Practitioner in 1 Securities Law & The Internet: Doing Business in a Rapidly Changing Marketplace (PLI Corp. L. & Prac. Course Handbook Series No. B0-00BS, June-July 1999).

Section 11 of the Securities Act of 1933, investors were excluded from such presentations[3]. The concept of a road show as we know it today was originated in the 1970s by a small investment bank. Lacking an extensive sales force, the investment bank invited potential investors to mass road show meetings as a way to reach a large number of investors at once[4].

In recent years there has been an increasing demand from large institutions for "one on one" meetings with management in the investors' own offices. One-on-one meetings allow investors to address their specific concerns in much greater detail. Although one-on-one meetings are more costly and time consuming than traditional road show presentations, the buying power of large institutional investors and the opportunity for an issuer to develop long-term relationships has made one-on-ones an important part of the road show process.

Today road shows are prepared with great care. As road shows became a more important part of the marketing process underwriters began to play a significant role in the preparatory stages. Most large investment banks "now employ several people in their syndicate departments who do nothing but orchestrate the petty details of road shows[5]." The lead underwriter assists management in preparing and rehearsing its presentation, including putting management through a series of "dry-runs" with the investment bankers and sales force[6].

The most important recent development in road shows has been the introduction of electronic road shows. The use of new technology such as the Internet to transmit road show presentations will allow broader access to road show presentations thereby leveling somewhat the playing field between large institutional investors who have typically enjoyed road show access and smaller investors, including individual investors, who have not.

3. Statutory Framework - application of the Securities Act of 1933 and the Securities Exchange Act of 1934 to registered and unregistered offering.

- Registered Offerings
    - Free Writing

Under Section 5(b)(1) of the Securities Act, any prospectus used in a registered securities offering must meet the requirements of Section 10 of the Securities Act. The term "prospectus"

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3 Charles Schwab & Co., Inc., SEC No-Action Letter, (November 15, 1999).

4 Tom Pratt, On the Road Again..., Investment Dealers' Digest, September 20, 1993.

5 Id, at 14.

6 Supra, note 2.

is defined broadly in Section 2(a)(10) of the Securities Act to include any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security.

Any written communication regarding an offering which is distributed to investors at a road show may constitute a "prospectus" that must conform to the requirements of Section 10 of the Securities Act. Presentation materials such as slides, charts or graphs used during road shows do not meet such requirements and might be considered impermissible "free writing" in violation of the Securities Act. Accordingly, the only materials that should be distributed to investors at a road show are the preliminary prospectus. Documents incorporated by reference in the prospectus may also be distributed, but this is not common practice.

- Actionable False or Misleading Statements

The road show presentation constitutes an offer of the subject securities. These offers are permissible because road shows take place during the "waiting period", the period of time between the filing with the Securities and Exchange Commission of a registration statement relating to a securities offering and the effectiveness of the registration statement. During this period, written and oral offers are permitted (although oral offers made on radio or television may be deemed a prospectus subject to the requirements of Section 10 of the Securities Act).

Although oral offers are permissible, statements made during a road show are still subject to the anti-fraud provisions of Section 12(2) of the Securities Act and Rule 10b-5 of the Exchange Act. Accordingly, false or misleading statements or omissions of material facts made during the road show will expose the issuer and underwriters to anti-fraud liability. Management might be tempted to make overly optimistic statements to attract investors. In order to avoid this risk, counsel often advises management to limit the information provided in the road show presentation to what is contained in the preliminary prospectus.

- Material Omissions (Webvan)

In making a disclosure during a road show that goes beyond the disclosure in the preliminary prospectus, the offering participants risk the claim that the preliminary prospectus contains a material omission. The Securities and Exchange Commission has recently reminded issuers of this selective disclosure risk. In October 1999, Webvan Group Inc., an online grocery retailer, had to postpone its IPO after it released financial information during its road show that was not contained in the preliminary prospectus and had given several press interviews during the waiting period. The information provided at the road show appeared in TheStreet.com, an online business publication, after one of its reporters listened in on a road show presentation

through a conference call hookup[7]. The IPO was delayed after the Securities Exchange Commission expressed its concern that the statements that had been made during the road show should have been contained in the preliminary prospectus. Webvan subsequently recirculated a revised preliminary prospectus that contained the missing information that had been provided at the road show. This type of incident can put the success of an offering at risk by causing a delay that results in the offering missing a "window" of favorable market conditions and exposes the issuer to additional liability with respect to the information required to be disclosed in the prospectus.

In a recent Securities Exchange Commission release relating to selective disclosure[8], discussed in more detail below, the Securities Exchange Commission has proposed a new rule which would require all reporting issuers to publically disclose[9] any material information orally communicated at road shows.

- Private Securities Litigation Reform Act

In December 1995, Congress passed the Private Securities Litigation Reform Act of 1995. A major feature of the Reform Act is the safe harbor it provides for oral and written "forward-looking statements" made by an issuer, its officers, directors and employees or by an underwriter with respect to information provided by such issuer or information derived from information provided by such issuer[10]. The safe harbor is applicable to any private action arising under the Securities Act or the Exchange Act in which the claim is based on an untrue or misleading statement of a material fact relating to a forward-looking statement. The safe harbor provision is only available to issuers that are subject to the reporting requirements of the 1934 Act and does not cover statements made in an initial public offering. Additionally, the provision is only applicable to private civil suits and does not cover Securities Exchange Commission enforcement actions.

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7 The "Quiet" Question: A Debate Reopens Over Disclosures During a Stock Offering, Wall St. J., October 1999, at C1.

8 Securities Act Release Nos. 33-7787, 34-42259 (December 20, 1999), SEC LEXIS 2696.

9 Public disclosure could be achieved through an 8-K, press release issued through a widely circulated news or wire service or "any other method of disclosure that is reasonably designed to provide broad public access". Securities Act Release Nos. 33-7787, 34-42259 (December 20, 1999), SEC LEXIS 2696.

10 Securities Act § 27A(c)(1)(B).

The safe harbor provision applies to any oral or written forward-looking statement if:

(A) The forward-looking statement is:

(i) Identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or

(ii) Immaterial; or

(B) The plaintiff fails to prove that the forward-looking statement:

(i) If made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or

(ii) If made by a business entity; was:

(I) Made by or with the approval of an executive officer of that entity; and

(II) Made or approved by such officer with actual knowledge by that officer that the statement was false or misleading[11].

The safe harbor also protects oral statements, including oral statements made during road shows, of officers, directors and employees of an issuer as long as the speaker identifies the statements as forward-looking statement, states that actual results could differ materially from those expressed and refers the audience to readily available written information which identifies the factors that could cause actual results to differ. This would allow management to make forward-looking statements, such as projections, on a road show without having to list all of the factors that could cause actual results to differ, assuming such factors were listed in a readily available document, such as the preliminary prospectus. The ability to incorporate such factors by reference to a document is not available to underwriters. Accordingly any forward looking statements made by an underwriter on a road show would need to include all of the necessary cautionary statements to be included in the safe harbor.

Issuers have remained hesitant about making forward-looking statements, especially financial projections, in prospectuses despite the safe harbor provided by the Reform Act. There is still a degree of uncertainty as to what the actual requirements are to fall into the safe harbor. Until these requirements have been clarified by the Securities Exchange Commission or courts, such hesitation is likely to continue. Additionally, because the Reform Act does not preempt actions brought in state court, issuers are still exposed to liability for forward-looking statements in state court actions where the safe harbor does not apply. An issuer may,

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11 Securities Act § 27A(c)(1)(B).

however, be tempted to make such projections at the road show where the audience is limited to a group of sophisticated institutional investors. As discussed above, this selective disclosure is risky.

- Unregistered Offerings

    - Prohibition on General Solicitation and Advertising

Like public offerings, road shows are an important part of the marketing process in private placements made pursuant to Rule 144A under the Securities Act. However, road shows organized in connection with these offerings raise different issues than those raised in registered offerings. The main concern in a Rule 144A offering is that the road show might be conducted in violation of the rules against general solicitation and general advertisement. Accordingly, precautions must be taken to ensure that only QIBs are invited to and attend the Rule 144A offering road show.

    - No Obligation to Use a Complying Offering Document

Unlike registered offerings, there is no statutory requirement to use an offering document that complies with Section 10 of the Securities Act in a private placement. However, any materials distributed at a road show are still subject to anti-fraud liability. Additionally, wide spread distribution of written materials may result in a violation of restrictions on general solicitation. For these reasons it is advisable to distribute only the offering circular at a road show in connection with a private placement.

4. Practical Guidance

- Distribution of Preliminary Offering Document

The primacy of the prospectus must be kept in mind at all stages of the road show. Although there is no statutory requirement to distribute a preliminary prospectus during the road show it is advisable to do so.

- No Distribution of Other Materials

Slides, hard copies of speeches, video tapes and promotional materials in general must not be distributed at the road show. These materials may be considered nonconforming prospectuses in violation of Section 5 of the Securities Act.

- Consistency with Offering Document

Underwriters and management should make sure to limit management's presentation and answers to questions asked during the road show to information that is consistent with

information contained in the preliminary prospectus. Projections and other forward looking statements should not be made unless they are in the preliminary prospectus.

5. Recent Development - electronic road shows

- The Legal Issues

  - Registered Offerings

Electronic road shows present many advantages for underwriters and issuers since they are both less costly and time-consuming than traditional road shows. They also allow issuers to reach a wider pool of investors. However, before 1997, there was concern that an electronic road show might be deemed a non-conforming prospectus in violation of Section 5 of the Securities Act. As discussed above, the term prospectus is defined broadly in Section 2(a)(10) of the Securities Act to include any prospectus, notice, circular, advertisement, letter or communication, written *or by radio or television,* which offers any security for sale or confirms the sale of any security (emphasis added). Electronic road shows would be deemed prospectuses only if such transmissions were viewed as radio or television transmissions within the meaning of Section 2(a)(10). The Securities Exchange Commission addressed this issue in a series of no-action letters relating to the electronic broadcast of road shows. Electronic road shows that follow certain procedures outlined in these letters will not be deemed prospectuses within the meaning of Section 2(a)(10). Those procedures are discussed more fully below.

- Review of Securities Exchange Commission No-Action Letters

In 1997, the Securities Exchange Commission issued the first of seven no-action letters in connection with the transmission of road shows on a real-time or delayed basis on a closed circuit systems or over the Internet.[12] In analyzing the seven no-action letters issued by the Securities Exchange Commission, common restrictions and requirements are found in each proposal:

> <u>Limited Audience</u>: An essential component of all of the proposals was that only qualified investors would be able to access the electronic road show. In PFN only its subscribers, principally registered broker-dealers and investment advisers would be allowed to view transmissions. Net Roadshow I, Bloomberg, TFS and Activate would only permit viewers that are institutional investors and other investors of the type that would customarily attend road shows who have been authorized by the underwriters of

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12 The seven no-action letters are Private Financial Network, (March 12, 1997), ("PFN"); Net Roadshow, Inc. (September 8, 1997) ("Net Roadshow I"); Bloomberg L.P. (December 21, 1997) ("Bloomberg"); Net Roadshow Inc. (January 30, 1998) ("Net Roadshow II"); Thomson Financial Services, Inc. (September 4, 1998) ("TFS"); Activate.net Corporation (September 21, 1999) ("Activate"); and Charles Schwab & Co., Inc. (November 15, 1999) ("Schwab").

the offering to view presentations. Net Roadshow II which relates to the transmission of road shows for 144A offerings would only allow QIBs to view transmissions. Charles Schwab, discussed in more detail below, was the only no-action letter that proposed providing access to retail customers that met certain financial criteria. Generally access would be controlled through the use of a password.

Limited Viewings: Each of the proposals limited the viewers' access to the road show presentation. These limitations ranged from restricting investors to two viewings of a particular road show to providing investors with a "one day pass" that would entitle them to an unlimited number of viewings during a 24 hour period.

Content: All of the proposals with the exception of RoadShow II require the issuer and/or underwriter to take steps to ensure the information disclosed at the road show is not inconsistent with the prospectus. Road shows will be transmitted live or on a delayed basis. Presentations transmitted on a delayed basis will be shown in their entirety, though "dead time" may be edited out and issuers and underwriters will be given the opportunity to edit out misstatements or mistakes. In the event information changes subsequent to the live road show most proposals would display a periodic crawl on the screen with a synopsis of the changes and details on who the viewer should contact for further information. The later letters would allow viewers to interrupt the viewing and view less than the entire road show.[13] Those proposals that contemplate live transmissions would provide viewers with the opportunity to transmit questions to the issuer or underwriters at the road show.

Primacy of the Prospectus: Most of the proposals require the issuer or underwriter to deliver a prospectus to the viewer prior to their viewing the transmission. As an alternative, in Roadshow I each transmission would display a large button reading "Preliminary Prospectus" at all times. Viewers who click on the button can view and print the preliminary prospectus. Roadshow II would also display a button that would allow viewers to view the offering memorandum but not to print it. Each proposal provides for statements at the beginning or end of the presentation and/or periodic crawls across the screen emphasizing the importance of the prospectus and referring viewers to the prospectus for more complete information about the offering. No road shows will be transmitted prior to the filing of a registration statement with the Securities and Exchange Commission.

Restrictions on copying: Under all of the proposals viewers would be required to agree not to copy, transmit or distribute any road show materials. For example, in Net Roadshow I, viewers could not access a road show presentation unless they agreed to

[13] As the proposals pointed out, this would correspond to the ability of a member of the actual road show audience to arrive late, leave the room at any time and reenter.

not to copy, download or distribute any road show material. Throughout the road show the screen would carry a disclaimer reminding viewers of this restriction. In Bloomberg, TFS and Activate each road show transmission would begin and end with a warning message that "[b]y electing to view this transmission, you represent, warrant and agree that you will not videotape, record or otherwise attempt to reproduce or re-transmit the content of this transmission"[14]. Additionally Bloomberg, TFS and Activate each had technology that would prevent viewers from copying, downloading or printing any part of the road show transmission.

Compensation: Compensation for the service provider will not be tied to the size or success of the offering.

Rule 134(b) legend: Each presentation will include visual statements of the Rule 134(b) legend to the effect that the securities may not be sold and offers to buy cannot be accepted before the effective date of the registration statement.

In the no-action letters described above, a critical component of each proposal was that the issuer and underwriters would ensure that road shows would only be viewed by a limited audience of qualified investors consisting primarily of institutional investors and other market professionals. However, in a no-action letter delivered to Charles Schwab & Co., Inc. (November 15, 1999), the Securities Exchange Commission allowed Charles Schwab & Co., Inc. to provide access to Internet road shows for initial public offerings to certain of its retail investors [15]. In its request, Schwab maintained that institutional investors receive access to oral information at road shows that such investors "find useful in making investment decisions".[16] Schwab argued that such road show information should not be limited to institutional investors but should be made more broadly available. Apparently the Securities Exchange Commission agreed with this argument. In the Securities Exchange Commission's response to Schwab it stated "[o]ur position rests on policy considerations alone, including the Commission's goal of reducing selective disclosure of material offering-related information typically provided during road shows..."[17]. In its proposal, Schwab agreed to follow procedures to satisfy the conditions

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[14] Thomson Financial Services, SEC No Action Letter (September 4, 1998) LEXIS 1128 PLI/Corp 221, at 225; Bloomberg L.P., 1997 SEC No-Action LEXIS 1023, at 11 (Oct 22, 1997) SEC No-Action Letter (December 1, 1997); and Activate.net Corp., SEC No-Action Letter 1999, SEC No-Action LEXIS 766, at 11 (September 21, 1999).

[15] Road show presentations would be available to customers with at least 24 trades per year or at least $500,000 equity in household investment positions. Charles Schwab & Co., Inc. 1999 SEC No-Action LEXIS 903 (November 15, 1999)

[16] Id., at 13

[17] Id., at 14

outlined in the previous no-action letters relating to electronic road shows. Additionally, Schwab must be either a member of the sales or underwriting syndicate involved in the offering and is responsible for the content of the road shows it transmits.

- Unregistered Offerings

As discussed above, there is no statutory requirement to use an offering document that complies an offering document that complies with Section 10 of the Securities Act in a private placement. Accordingly, there is no issue as to whether an electronic road show would be considered a prospectus. Rather, the issue raised by electronic road shows organized in connection with Rule 144A offerings is whether such road shows are consistent with Rule 144A(d)(1) under the Securities Act which provides that offers and sales of securities in reliance on Rule 144A can only be made to QIBs or persons the seller reasonably believes are QIBs.

In a no-action letter delivered to Net Roadshow, Inc. (January 30, 1998), the Securities Exchange Commission took a no-action position with respect to Net Roadshow's transmission of road shows in connection with Rule 144A offerings over its Internet website. The Securities Exchange Commission's position was predicated on compliance with the following conditions:

- only institutions which the seller[18] has a reasonable belief are QIBs may view the roadshow;
- a unique confidential password is assigned to a QIB for a particular road show that will expire no later than the termination of the offering;
- each seller must represent that it is a QIB, each entity to which it has assigned a password is a QIB and the offering is not subject to registration under the Securities Act;
- Net Roadshow has no actual knowledge or reason to believe the seller is not a QIB, any of the entities to which the seller has assigned a password is not a QIB or the offering is subject to registration under the Securities Act;
- Net Roadshow is not an affiliate of any seller or issuer of a security that is the subject of a road show.

- Impact on Road Shows

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[18] The request defined a seller as a QIB or person acting on its behalf that purchases securities from an issuer for resale to other QIBs under Rule 144A.

Electronic road shows will provide a broader base of investors with access to road show presentations placing investors on a more level playing field. Additionally, investors will have more time to make fully informed investment decisions as road shows and preliminary prospectuses will be distributed faster. Finally, conscious of broader audiences (including, potentially, the Securities Exchange Commission), road show participants may become more precise and stick more closely to the contents of the preliminary prospectus[19]. While it is probable that the Securities Exchange Commission will continue to open up electronic road shows to a broader base of investors in an effort to provide investors with equal access, unless afforded greater protection by the Securities Exchange Commission many issuers and underwriters will choose to continue to exclude the general public from road shows for fear that they could lead to an increase in shareholders suits.

II. Analysts

1. Dual Role - Stock Analyst vs. Investment Banker

- Traditional Role as Stock Analyst

Traditionally, analysts act as investment advisors to their brokerage clients. By covering a particular stock or a particular industry analysts allow investors to make informed investment decisions. At the same time, analysts play an important role for companies and the market. Companies that benefit from analyst coverage have greater overall liquidity and a higher volume of their shares are traded. According to the Supreme Court: "the value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [analysts'] initiatives to ferret out and analyze information and thus the analysts' work redowns to the benefit of all investors"[20].

- Role as Part of Investment Banking Team
  - Soliciting Issuers

As part of an investment banking team, analysts play a major role in soliciting investment banking transactions including IPOs. Indeed, publications that keep track of which underwriters are most often selected to participate in an IPO often cite the analyst participating in the IPO as an essential factor in the issuer's choice of an investment banking firm. Often, an underwriter will be picked to participate in an offering based on the reputation and experience of the firm's analysts. In soliciting issuers, an underwriter will gain from the fact that one of its

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[19] Net Roadshows, Inc., SEC No Action Letter (September 8, 1997)

[20] Dirks v. Securities Exchange Commission, 463 U.S. 646 (1983).

analysts will be more willing to cover a particular company if the analyst's firm is chosen to manage the underwriting[21].

- Due Diligence

Analysts also play a major role in the underwriter's due diligence process. Indeed, based on their experience with an industry, analysts will be able to identify the weaknesses and strength of an issuer's products, management or strategies, and advise the issuer as to how these weaknesses or strengths should be presented in the prospectus.

- Sales and Marketing

One of the important aspects of an analyst's role in an offering is the analyst's credibility with sales persons and customers and the analyst's ability to provide earning estimates[22]. Institutional investors are not inclined to purchase shares without these estimates and depend on the analyst to make the estimates and to assess which of the issuer's projections are realistic and which are not.

2. Identification and Discussion of Related Issues

- Selective Disclosure by the Issuer and the Ability of the Analyst to Issue Research

Selective disclosure occurs when an issuer releases material nonpublic information on a limited basis prior to releasing the information to the public as a whole. An analyst working on a public offering and given access to an issuer's internal projections and other nonpublic information may be the beneficiary of selective disclosure. If the analyst utilizes this nonpublic information in a research report or while advising clients he risks violation of Rule 10b-5 for "insider trading". Insider trading refers to trading on material nonpublic information or conveying such information to someone who trades in violation of Rule 10b-5. Accordingly, when an analyst is "brought over the wall" in connection with an offering restrictions must be imposed on what the analyst can say or write about the issuer.

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[21] Herbert S. Wander, Jonathan J. Cope, Jonathan Dariyanani, Development in Disclosure Special Problems in Public Offerings (PLI Corp. L. & Prac. Course Handbook Series No. B4-7142, August 1996)

[22] Id.

- Overview of Case Law and Enforcement Actions

  - *Dirks v. Securities Exchange Commission*

The holding of the Supreme Court in *Dirks v. Securities Exchange Commission*[23] "is clearly the starting point for contemporary analysis of analyst contact"[24]. In *Dirks*, Raymond Dirks, an analyst at a broker-dealer, was informed by a former officer of Equity Funding of America that the company's assets were vastly overstated as a result of fraudulent practices. Dirks went to the company's headquarters to investigate the allegations and was able to corroborate the charges of fraud. Prior to the public disclosure of the fraud, Dirks openly discussed the information he had obtained with his clients some of whom sold their holdings in Equity Funding. The Securities Exchange Commission censured Dirks for selective disclosure under Rule 10b-5. The Supreme Court overturned the Securities Exchange Commission's censure of Dirks rejecting the idea that trading is prohibited whenever a person receives material nonpublic information from an insider. According to the Supreme Court the elements required for a violation of Rule 10b-5 are (i) the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee, (ii) the insider will personally benefit from his disclosure, and (iii) the tippee knows or should know that there has been a breach. Accordingly, since the former officer of the company had not benefitted from his disclosure to Dirks and Dirks while benefitting was not an insider of the company, Dirks had no duty to disclose or abstain from trading. In *Dirks* the Supreme Court stated "[i]mposing 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 Securities Exchange Commission itself recognizes is necessary to the preservation of a healthy market"[25].

  - *Securities Exchange Commission v. Stevens*

After *Dirks* the Securities Exchange Commission continued to pursue selective disclosure as a Rule 10b-5 insider trading violation. In *Securities Exchange Commission v. Stevens*[26] the Securities Exchange Commission diluted the impact of *Dirks* by issuing a broad interpretation of the personal benefit requirement. The Securities Exchange Commission filed a complaint against Phillip Stevens, the CEO and Chairman of Ultrasystems Corporation for violations of Rule 10b-5. Stevens, upon learning that Ultrasystems first quarter revenues would

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[23] Dirks v. SEC, 463 U.S. 646 (1983).

[24] Alan K. Austin & Clay B. Simpson, Interacting with Analysts (PLI Corp. L. & Prac. Course Handbook Series No. B0-00BH, at 96, November 1998).

[25] Dirks v. SEC, 463 U.S., at 658, 103 S.Ct., at 3263 (1983).

[26] SEC v. Stevens, 91 Civ. 1869 (CSH) Litig.Rel. No. 12813 (March 19, 1991).

be materially lower than expected, called several securities analysts that covered Ultrasystem to inform them of this information. Two of the analyst passed on the information to their clients who then sold their shares in Ultrasystem.

According to the Securities Exchange Commission, Stevens placed the analyst calls to "protect and enhance his reputation" and he viewed these calls as "having direct, tangible benefit to his status as a corporate manager"[27]. Stevens agreed to pay a fine equal to the amount of losses avoided by the shareholders who sold their shares based on the inside information. As one commentator notes:

> [t]he danger of the Commission's rationale in *Stevens* is that virtually all selective disclosures are likely to have been made on some element of personal motivation. Thus, any executive, even one who is driven by a desire to serve the corporation, may be charged with deriving a "reputational benefit" when he or she communicates with analysts.[28]

- *Securities Exchange Commission v. Rosenberg*

In *SEC v. Rosenberg*[29] the Securities Exchange Commission alleged that Baruch Rosenberg, a securities analyst, had a conversation with an officer of Appollo Computer Inc. in which the officer expressed concern about the ability of the company to meet second quarter earnings because one of the company's large customers was not taking all of the shipments that had been anticipated. Rosenberg liquidated his own position in the company prior to Appollo's public announcement of its expected loss. He did not share the information he learned with his firm or customers. The Securities Exchange Commission used a "misappropriation theory" against Rosenberg. Instead of taking action against the tipper or alleging the tipper had breached a fiduciary duty, the Securities Exchange Commission maintained Rosenberg had breached a duty owed to his firm and its clients by trading on information obtained in the workplace.[30] Rosenberg settled with the Securities Exchange Commission and agreed to disgorge an amount equal to the losses he avoided, pay a civil penalty and not associate with a broker-dealer for a twelve month period.

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[27] Supra, note 24.

[28] Supra Note 21, at 444.

[29] Litigation Rel. 12986, 49 SEC Dkt. (CCM) 1373 (Sept. 24, 1991)

[30] Harvey L. Pitt, Karl A. Groskaufmanis, The National Law Journal, at B4, April 25, 1994.

In *United States v. O'Hagan*[31] the Supreme Court affirmed the Securities Exchange Commission position in *Rosenberg* that selective disclosure may be a violation of Rule 10b-5 under the misappropriation theory. As one commentator noted:

> [t]he Rosenberg case demonstrates that it is prudent for securities firms to think of selective disclosure in terms of "legal risk" and "investigative risk." Dirks diminished the legal risk significantly, but this relief only becomes available conclusively once a matter becomes the subject of litigation — and its attendant publicity. Rosenberg and ...Stevens underscore that a continuing investigative risk remains in using material information that has been disclosed selectively. Dirks has not dampened the Securities Exchange Commission's resolve to look closely at trading on such information. Investigative risk requires securities firms to factor in the potential cost, time and emotional strain that accompanies any government inquiry.[32]

- Securities Exchange Commission Release on Selective Disclosure and Insider Trading

In a recent release[33] the Securities Exchange Commission addresses the issue of selective disclosure by issuers by proposing a new rule. The proposed rule aims to addresses Securities Exchange Commission concerns that analysts are often the beneficiaries of selective disclosure:

> [a]lthough analysts play an important role in gathering and analyzing information, and disseminating their analysis to investors, we do not believe that allowing issuers to disclose material information selectively to analysts is in the best interest of investors or the securities market generally. Instead, to the maximum extent practicable, we believe that all investors should have access to an issuer's material disclosures at the same time[34].

Proposed Regulation FD (Fair Disclosure), therefore would require that whenever:

(1) an issuer, or any person acting on its behalf,

(2) discloses material nonpublic information,

(3) to any other person outside the issuer,

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

32 Supra, note 29, at B4.

33 Supra, note 8.

34 Id.

(4) the issuer must:

(a) simultaneously (for intentional disclosures), or

(b) "promptly" (for non-intentional disclosures),

(5) make public disclosure of that same information.[35]

The Rule would allow an issuer to share material nonpublic information with outsiders who agree to keep the information confidential. Accordingly, the Rule would not apply to disclosures made to persons "who are bound by duties of trust or confidence not to disclose or use the information for trading"[36]. This would include several types of persons such as investment bankers, attorneys, consultants, accountants and presumably an analyst who has "crossed over the wall". Therefore, if during the diligence process the issuer revealed material nonpublic information to its bankers, including the analyst who has crossed over the wall and is wearing a banker's hat, the issuer would not be obligated to disclose the information to the public under the proposed Regulation FD. However, misuse of the information by the bankers would subject them to insider trading liability under Rule 10b-5 as "temporary" insiders of the issuer.

Issuers who do not comply with Regulation FD will be subject to a Securities Exchange Commission enforcement action for violation of disclosure obligations under Sections 13(a) and 15(d) of the Exchange Act and Section 30 of the Investment Company Act. While Regulation FD is not an antifraud rule and will not subject an issuer to private liability, it does not affect any existing bases of liability under Rule 10b-5. Accordingly, liability for "tipping" under Rule 10b-5 may still exist if a selective disclosure is made in circumstances that meet the *Dirks* "personal benefit" test. Regulation FD only applies to reporting companies and would not apply during an IPO prior to the effectiveness of the registration statement.

- Measures to Prevent Selective Disclosure Liability

When an analyst is "brought over the wall" in connection with an offering certain measures should be imposed by the investment banking firm to avoid liability under Rule 10b-5:

- Formal training sessions for analysts with the investment banking firm's legal department should be implemented to ensure that analysts are aware certain

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35 Supra, note 8, at 22.

36 Id. at 30.

information they receive during the diligence process in an offering is confidential and may not be used in their role as an analyst.[37]

- Analysts should not reveal any material nonpublic information to clients or in research reports until such information is stale or has become public. Analysts should work closely with the firm's legal department to determine what may be deemed "material".

- [Some investment banks have a policy which requires analyst to leave the room when projections are discussed in the diligence process].

- Entanglement

In addition to risks of selective disclosure, when an analyst participates in the diligence process an issuer risks entanglement. Under the entanglement theory, an issuer may be held liable under Section 10(b) for fraudulent statements and omissions in an analyst's report. This can occur when an issuer becomes responsible for what is contained in an analysts report by placing its imprimatur, expressly or impliedly, on the analyst's statements. Entanglement can also occur when an issuer provides information to an analyst which is reproduced in the analyst's report. Additionally, if an analyst's report is attributable to the issuer, the issuer may have a duty to update and correct material errors or omissions contained in the analysts report.[38]

- Measures to Avoid Entanglement

The measures to avoid entanglement when an analyst "climbs over the wall" includes some of the same measures that should be taken to avoid entanglement generally:

- The issuer should avoid reviewing the analysts research report. If an issuer does review the report it should be limited to factual matters and not opinions or projections. Additionally, a written record should be kept of any changes that were suggested.

- Disclosure should be accurate and complete. Management should have a "reasonable basis" for any statement made to an analyst Projections that turn out to be incorrect in the future will not subject an issuer to liability unless they were untrue or unreasonable

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[37] Julia B. Strickland, David Neier, Regulation of Security Analysts (PLI Corp. L. Prac. Course Handbook Series No. B4–7141 (October-November, 1996).

[38] Supra, Note 20

at the time they were made. In one case the court found officers were not liable for opinions with a reasonable basis because this would constitute "fraud by hindsight"[39].

- When past statements are no longer accurate the issuer should consider updating or correcting.

[39] James J. Junewicz, Handling Wall Street Analysts, Insights, Volume 9, Number 1, January 1995, quoting Schwartz v. Novo Industry, A/S, 658 F. Supp. 795 (S.D.N.Y. 1987).