

## NEW SEC RULES ON SELECTIVE DISCLOSURE AND INSIDER TRADING

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The Securities and Exchange Commission (the "SEC") adopted new rules in a release dated August 10, 2000 (the "Release") to address:

- selective disclosure of material nonpublic information;
- whether insider trading liability depends on a trader's "use" or "knowing possession" of material nonpublic information; and
- when breaches of family or other non-business relationships can give rise to liability under the misappropriation theory of insider trading.

The rules are based on the rules proposed in the SEC release dated December 20, 1999 (the "Proposing Release") and have been modified as a result of comments received by the SEC. The new rules will take effect on October 23, 2000.

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### EXECUTIVE SUMMARY

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The new Rules:

- Require that, whenever an issuer, or a person acting on an issuer's behalf, intentionally discloses material nonpublic information to securities market professionals and holders of the issuer's securities who may trade on the basis of the information, the issuer must make simultaneous public disclosure of that information. If the issuer unintentionally discloses material information, it must "promptly" make public disclosure of such information.
- Provide that insider trading liability arises when a person trades while "aware" of material nonpublic information. The Rule provides certain exceptions to liability where a trade was executed pursuant to a pre-existing contract, instruction or written plan.
- Establish three non-exclusive bases for determining that a duty of trust or confidence was owed by a person receiving insider information:
  - when the person agreed to keep the information confidential;

- when the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; and
- when a person provides information to a spouse, parent, child, or sibling unless it were shown, based on the facts and circumstances of that family relationship, that there was no reasonable expectation of confidentiality.

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**SELECTIVE DISCLOSURE**

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**GENERAL**

The SEC has adopted a new regulation, Regulation FD (Fair Disclosure), to address its concerns over selective disclosure. Selective disclosure occurs when an issuer releases material nonpublic information on a limited basis, such as to a group of analysts or institutional investors, prior to releasing the information to the public as a whole. In the Proposing Release and the Release, the SEC discusses several unfavorable consequences of selective disclosure, including:

- loss of investor confidence in the integrity of the capital markets which results when persons with access to selective disclosures make a quick profit or minimize losses by trading on the information before it is public;
- delayed disclosure of information to the public by issuers so they can use the information as a commodity to “curry favor or bolster credibility with particular analysts or institutional investors”; and
- increased pressure on analysts to report favorably about an issuer to avoid being denied access by the issuer to conference calls or other means of selective disclosure.

Accordingly, in an effort to level the playing field among large and small investors, the new Regulation establishes requirements for full and fair disclosure of material information by public companies.

As a result of the nearly 6,000 comments received in response to the Proposing Release, the SEC has made significant changes to Regulation FD. Some changes are substantive and serve to narrow the scope of the regulation – others merely clarify perceived ambiguities.<sup>1</sup>

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1. The regulation as proposed is referred to as the “Proposed Regulation”. The regulation as adopted is referred to as the “Regulation” or “Final Regulation”.

## REGULATION FD (FAIR DISCLOSURE)

Under the Regulation, whenever an issuer makes an intentional disclosure of material nonpublic information to securities market professionals and holders of the issuer's securities who may trade on the basis of the information, it must disclose the information through public disclosure, rather than through selective disclosure. If an issuer unintentionally discloses material nonpublic information on a selective basis it must publicly disclose the information promptly after it learns of the selective disclosure.

### **Issuers Subject to Regulation FD**

The Regulation applies to reporting companies, including closed-end investment companies. It does not apply to: (a) any foreign government or foreign private issuer; or (b) any investment company other than a closed-end investment company.

### **Issuer Personnel Covered by the Regulation**

The Regulation applies to disclosures made by any issuer or "persons acting on behalf of an issuer." These persons include any senior official of the issuer or any other officer, employee or agent of the issuer who regularly communicates with securities market professionals or with holders of the issuer's securities. The Regulation defines senior official as any executive officer, director, investor relations officer, public relations officer or employee with equivalent functions. An issuer cannot get around the Regulation by having a lower level employee make a selective disclosure if that employee has been directed to make such disclosure by a senior official. If an employee or agent of the issuer discloses material nonpublic information "in breach of a duty of trust or confidence to the issuer," that person will not be considered to be a "person acting on behalf of the issuer."

Under the Proposed Regulation, a "person acting on behalf of the issuer" was defined as "[a]ny officer, director, employee, or agent of the issuer" The Final Regulation modifies this definition to reflect the concerns of commenters that the proposed definition was too broad.

### **Persons an Issuer Cannot Provide with Selective Disclosure**

The Regulation applies only to communications to certain securities market professionals, such as:

- broker-dealers or persons associated with broker-dealers;
- investment advisors or persons associated with an investment advisor;
- institutional investment managers or persons associated with an institutional investment manager; or
- investment companies.

The Regulation also applies to communications to holders of the issuer's securities, if under the circumstances it is reasonably foreseeable that such person will trade on the basis of the information.<sup>2</sup> The public disclosure requirement would not be triggered by issuer disclosure to

- persons who owe a duty of trust or confidence to the issuer such as attorneys, investment bankers or accountants;
- persons who have expressly agreed to keep the information confidential; or
- rating agencies.<sup>3</sup>

### **Material Nonpublic Information**

#### **Material Information**

Although the Regulation prohibits selective disclosure of "material nonpublic information", it does not define "material" or "nonpublic". The Release states that the SEC intends to rely on the standard definitions of material and nonpublic generally used under federal securities laws. Under these definitions information is deemed material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision, or if it would have "significantly altered the 'total mix' of information made available."<sup>4</sup> In the Release, the SEC lists a number of types of information or events that should be reviewed carefully to determine whether they are material:

- earnings information;

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2. The Proposed Regulation applied to communications to "any person or persons outside the issuer." To reflect commentators concerns that this definition would inappropriately interfere with ordinary-course business communications, such as discussions with suppliers or customers, the Final Regulation has been narrowed.
  3. These persons would still be subject to insider trading liability under Rule 10b-5 if the information was misused for trading.
  4. SEC Release Nos. 33-7881, 34-43154 (August 10, 2000) at 8 quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); see *Basic v. Levinson*, 485 U.S. 224, 231 (1988) (materiality with respect to contingent or speculative events will depend on a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of company activity); see also Securities Act Rule 405, 17 CFR 230.405; Exchange Act Rule 12b-2, 17 CFR 240.12b-2; Staff Accounting Bulletin No. 99 (Aug. 12, 1999) (64 FR 45150) (discussing materiality for purposes of financial statements).

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

The SEC stated in the Release it does not mean to imply each of the items listed above is per se material and the information and events on this list still require determinations as to their materiality.

### **Earnings Guidance**

In the Release the SEC discussed special concerns about selective disclosure raised by the practice of analysts seeking guidance from issuers regarding earnings forecasts. The Release states that private discussions between an issuer and an analyst seeking guidance about earnings estimates entails “a high degree of risk under Regulation FD.” In the SEC’s view selective disclosure to an analyst of nonpublic information that the issuer’s anticipated earnings will be higher, lower or even the same as what analysts have been forecasting will likely violate the Regulation. This would apply for express communications about earnings as well as to indirect guidance the meaning of which is apparent though implied. The Release also states that “an issuer cannot render material information immaterial simply by breaking it into ostensibly non-material pieces.” This however, would not preclude an issuer from providing an analyst with non-material information “even if, unbeknownst to the issuer, that piece helps the analyst complete a “mosaic” of information that, taken together, is material.”

### **Nonpublic Information**

The Release states that information is nonpublic if it has not been disseminated in a manner making it available to investors generally.

## Corrective Disclosure under Regulation FD

### Intentional Disclosure

Intentional disclosures of material nonpublic information must be publicly disclosed simultaneously, eradicating any intentional selective disclosure. A disclosure is intentional when “the person making the disclosure either knows, or is reckless in not knowing, that the information he or she is communicating is both material and nonpublic.” Accordingly, if an issuer makes a mistaken determination of materiality, liability would only arise if “no reasonable person under the circumstances would have made the same determination.”

### Unintentional Disclosure

Communications would be unintentional if they were made through an honest slip of the tongue or in the mistaken belief (without reckless disregard of the truth) that the information was already public or was not material. Unintentional disclosures must be publicly disclosed “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) of the non-intentional disclosure.”

### Method of Public Disclosure

- The “public disclosure” requirement of the Regulation can be satisfied by:
  - filing a Form 8-K<sup>5</sup> or
  - disseminating the information through another method, or combination of methods, of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public.

The Release provides the following example of how an issuer could employ a combination of methods to disclose material information, such as an earnings release:

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5. Form 8-K has been modified as follows: an issuer can file a report under Item 5 (Other Events) or furnish a report under a new Item 9 (Regulation FD Disclosure). 8-K’s that are furnished instead of filed will not be automatically incorporated by reference into an issuer’s Securities Act registration statements and will not be subject to liability under Section 11 of the Securities Act or Section 18 of the Exchange Act. The revised Form 8-K states that an issuer’s report under Item 5 or 9 “will not be deemed an admission of the materiality of any information that is required to be disclosed solely by Regulation FD.”

- issue a press release containing the information;
  - provide adequate notice through a press release and/or web posting of a conference call to discuss the information, including the time and date of the call and how to access the call; and
  - conduct the conference call in an open manner either by telephonic means or Internet webcasting.<sup>6</sup>
- At present the SEC does not consider posting information on an issuer’s website to be by itself a sufficient method of public disclosure.<sup>7</sup> As described above, websites can however be part of a combination of methods used by an issuer to provide broad distribution of information to the public.
- The Release emphasizes that an issuer is given considerable flexibility in choosing the method of public disclosure that is “reasonably designed” to effect broad non-exclusionary disclosure of information to the public. When evaluating whether an issuer’s method of disclosure was reasonable the SEC “will consider all the relevant facts and circumstances, recognizing that methods of disclosure that may be effective for some issuers may not be effective for others.” For example, for an issuer whose press releases are routinely not picked up by the major business wire services, public disclosure made solely by submitting a press release to one of these wire services may not be enough to meet the public disclosure requirements without the use of additional methods of dissemination.
- If an issuer deviates from its usual practices for making public disclosure it may affect the SEC’s judgment as to whether the method of disclosure used was reasonable. It cites as an example that if an issuer that typically discloses quarterly earnings in a press release replaces such method with a last minute webcast of quarterly results made at the same time as an otherwise selective disclosure of that

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6. An issuer would not be obligated to provide all participants on a call the opportunity to ask questions – “listen only” calls would satisfy the requirements of the Rule. The Release states that issuers using a webcast or conference call should consider providing a means for making the webcast or call available for some reasonable period of time to enable persons who missed the original webcast or call to access the disclosure at a later time.
7. The SEC does acknowledges that in the future as more investors have access to and use the Internet an issuer with a website widely followed by the investment community may be able to use such a method.

information, the SEC may be skeptical to a claim by the issuer that such method provides broad non-exclusionary public disclosure of the earnings.

### **Effect of Noncompliance**

Issuers who do not comply with Regulation FD will be subject to an SEC enforcement action for violation of disclosure obligations under Section 13(a) and 15(d) of the Securities Exchange Act of 1934 and Section 30 of the Investment Company Act of 1940. In response to the Proposed Regulation, commenters expressed the concern that Regulation FD may have a substantial “chilling effect” on issuer disclosures. To alleviate this concern, the Final Regulation expressly provides that it is not an antifraud rule,<sup>8</sup> and that it does not create any private cause of action. Furthermore, a violation of Regulation FD will not affect whether an issuer is considered current or, where applicable, timely in its Exchange Act reports, for purposes of the issuer’s eligibility for short-form Securities Act registration or the availability of Rule 144. However, Regulation FD will not affect any existing basis of liability under the general antifraud rule, Rule 10b-5. Even though a violation of Regulation FD does not give rise to a private right of action, it is possible that a failure to comply with the Regulation could nevertheless be used as evidence in a Rule 10b-5 action.

### **Regulation FD and Securities Offerings**

- With limited exceptions, the Regulation does not apply to disclosures made in connection with a registered securities offering.<sup>9</sup> The SEC believes that the Securities Act already accomplishes at least some of the policy imperative of Regulation FD. However, even if an issuer is in the midst of a registered offering, any communications that are not made in connection with the offering are not exempt for the Regulation. For example, communications about future financial performance made at a regularly scheduled conference call with

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8. Issuers who have recently violated antifraud provisions of the securities laws may not assert that a disclosure is protected by the safe harbor provisions of the Private Securities Litigation Reform Act (the “Reform Act”). The Proposed Regulation was modified to make it expressly clear that Regulation FD is not an antifraud rule and that failure to make a disclosure required by Regulation FD will not provide a sufficient basis for a Rule 10b-5 violation. Because Regulation FD is not an antifraud rule, a violation of Regulation FD should not affect the availability of the Reform Act’s safe harbor.
  9. Commentators expressed the concern that the required public disclosure could be considered an “offer” under Section 5 of the Securities Act. If the disclosure was made in writing or broadcast on radio or television it could be considered a prospectus that fails to conform to the requirements of Section 10 of the Securities Act in violation of Section 5 of the Securities Act. The Proposed Regulation was modified to reflect this concern.

analysts would not be considered to be made in connection with an offering and would not be exempt from the Regulation simply because the issuer was in the midst of a registered offering.

- Unregistered securities offerings (including Rule 144A offerings) are not exempt from Regulation FD. Because such offerings are not subject to the disclosure obligations of the Securities Act, the SEC believes that disclosure under Regulation FD is appropriate even if, as a result of such disclosure, the availability of the Securities Act registration exemption may be in question. The Release does however state that if investors agree to maintain any information they receive from an issuer in confidence, the issuer would not need to publicly disclose the information under Regulation FD.

### **Observations**

The Regulation will have a significant impact on the way issuers interact with analysts and other securities market professionals:

- Issuers should define who are their senior officials and other employees who regularly communicate with securities market professionals or shareholders. These personnel should be briefed by the issuer's counsel on the Regulation. Issuers should also take measures to ensure that persons outside of this group of employees do not communicate with securities market professionals or shareholders.
- Issuers will be forced to carefully consider what types of interaction they wish to have with analysts especially outside of scheduled analysts meetings or conference calls. As discussed above, giving guidance (including indirect guidance) to analysts will likely trigger a disclosure requirement under Regulation FD, forcing an issuer to prematurely divulge information it did not yet wish to disclose to the public. Issuers may choose to enact tighter controls on analyst communications or restrict all one on one communications with individual analysts outside of scheduled analyst meetings. While one on one communications are not prohibited by the Regulation, they do create a greater risk of selective disclosure.
- Issuers may decide to adopt a policy mandating that all analyst meetings or conference calls follow the method of public disclosure outlined above (issuing a press release, notice of the meeting or call and access to the call by telephonic or Internet webcasting). If an issuer follows these procedures, any material disclosure made during the meeting or call would not be considered selective disclosure, even if the information was not previously disclosed in the issuer's press release. The SEC has not provided guidance as to how much time needs to

elapse between the issuance of notice of a meeting or call and the actual event to constitute adequate notice.

- Issuers who will be attending an industry conference or sponsoring a company conference should consider issuing a press release notifying the public that it will be making the transcript of the issuer's presentation at such conference available on the issuer's website and posting the transcript on the website simultaneously with such presentation.
- With respect to disclosures made in connection with unregistered offerings, such as disclosures made at a road show for a Rule 144A offering, which are not exempt from Regulation FD, issuers are likely to be advised by counsel to obtain some assurance that the information will be treated confidentially.
- Trade organizations, such as National Investors Relations Institute, will most likely play an important role in establishing "best practices" for issuers. These organizations will provide valuable guidance to issuers in the upcoming months while uncertainty about the Regulation and its implications are high.

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#### INSIDER TRADING ISSUES

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The SEC also adopted rules to address two issues in insider trading law that have been the subject of disagreement among various courts.

#### **RULE 10b5-1: TRADING "ON THE BASIS OF" MATERIAL NONPUBLIC INFORMATION**

Rule 10b5-1 addresses the unsettled issue in insider trading law of whether it must be shown the defendant "used" the insider information he or she possessed in trading or is it enough to show that the defendant was in "knowing possession" of the information when he or she traded. Under the Rule, if a trader "was aware of" material nonpublic information when he or she made the trade, he or she has violated Rule 10b-5. The Rule provides specific affirmative defenses against liability designed to cover situations in which a person can demonstrate that the material nonpublic information was not a factor in the trading decision.

The primary affirmative defense set forth in Rule 10b5-1 requires that a person demonstrate that a trade was executed under a pre-existing written plan, contract or instruction entered into in good faith. *First*, the trader must demonstrate that prior to becoming aware of the material nonpublic information, he or she had:

- entered into a binding contract to purchase or sell the security;
- provided instructions to another to execute the trade for the instructing person's account; or

- adopted a written plan for trading securities.

*Second*, the trader must show that the contract, instruction or plan either:

- expressly specified the amount, price, and date;
- provided a written formula or algorithm, or computer program, for determining amounts, prices and dates; or
- did not permit the trader to exercise any subsequent influence over purchases and sales.

*Third*, the trade must demonstrate that purchase or sale was executed pursuant to the contract, instruction or plan. To reflect commenter concerns that the affirmative defense provided for in the Proposed Regulation was too rigid, the Final Regulation has been slightly modified to provide for greater flexibility to those “who would like to plan securities transactions in advance at a time when they are not aware of material nonpublic information, and then carry out those pre-planned transactions at a later time, even if they later become aware of material nonpublic information.”

#### **RULE 10B5-2: DUTIES OF TRUST OR CONFIDENCE IN MISAPPROPRIATION INSIDER TRADING CASES**

Under the misappropriation theory of insider trading, a person that misappropriates material nonpublic information for trading purposes in breach of a duty of loyalty or confidence has violated Section 10(b) of the Exchange Act and Rule 10b-5. It has been established under case law that certain business or agency relationships such as attorney-client or employer-employee provide the duty of trust or confidence required under the misappropriation theory. However, it has not been established under what circumstances certain non-business relationships such as family and personal relationships provide the duty of trust or confidence necessary under the misappropriation theory.

Rule 10b5-2, adopted substantially as proposed, lists three non-exclusive bases for determining when a person receiving insider information was subject to a duty of trust or confidence under the misappropriation theory:

- when the person agreed not to disclose the information;
- when the person disclosing the information and the person receiving the information “have a history, pattern or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality”; or
- when a person receives information from a spouse, parent, child or sibling, unless it can be shown that no duty of trust or confidence existed by

establishing there was no expectation the person would keep the information confidential.

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