SEC PROPOSED RULE CHANGES ON SELECTIVE DISCLOSURE AND INSIDER TRADING

SIMPSON THACHER & BARTLETT LLP

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On December 20, 1999, the Securities and Exchange Commission (the "SEC") issued a release[1] (the "Release") proposing new rules to address (i) selective disclosure of material nonpublic information, (ii) whether insider trading liability depends on a trader's "use" or "knowing possession" of material nonpublic information and (iii) when breaches of family or other non-business relationships can give rise to liability under the misappropriation theory of insider trading. The proposals are subject to public comment on or before March 29, 2000. The SEC may, after the comment period, adopt the proposed rules or make additional proposals based on comments received.

EXECUTIVE SUMMARY

The proposed Rule changes set forth in the Release are summarized below and would:

- Require that, whenever issuers that are reporting companies intentionally disclose any material information to any person outside the issuer, they simultaneously make public disclosure of the same 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 would provide certain exceptions to liability where a trade was executed under a pre-existing plan, contract or instruction.
- Set forth three non-exclusive bases for determining that a duty of trust or confidence was owed by a person receiving insider information: (i) when the person agreed to keep the information confidential, (ii) when "the persons involved in the communication have a history, pattern or practice of sharing confidences that resulted in a reasonable expectation of confidentiality", and (iii) when a person

1. SEC Release Nos. 33-7787, 34-42259, IC-24209 (December 20, 1999).

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.

SELECTIVE DISCLOSURE

GENERAL

The SEC has proposed 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 Release the SEC discusses several unfavorable consequences of selective disclosure, including:

- allowing those with access to the selective disclosure to 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 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 proposes providing timely access to all investors of material information an issuer chooses to disclose.

The SEC recognizes that selective disclosure is not a new practice, but believes rule making measures are appropriate now as "the impact of such selective disclosure appears to be much greater in today's more volatile, earnings-sensitive markets...[and] a continued practice of selective disclosure by issuers inevitably will lead to a loss of public confidence in the fairness of markets." Additionally, while in the past issuers may have relied on analysts to serve as "information intermediaries" by passing on information to the public, changes in technology, including the Internet and closed circuit television, now allow issuers themselves to disseminate important information broadly and quickly without relying on such intermediaries.

REGULATION FD (FAIR DISCLOSURE)

Under the proposed Regulation, whenever an issuer makes an intentional disclosure of material nonpublic 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. The following is a summary of the proposed Regulation:

- The Regulation would apply to reporting companies, including any foreign private issuer subject to the reporting requirements of the Exchange Act. It would apply to closed-end investment companies but not other types of investment companies. The Regulation would not apply to an issuer during an IPO prior to the effectiveness of the registration statement.

- The Regulation would apply to disclosures made by any of the officers, directors, employees or agents of an issuer "acting within the scope of his or her authority." Accordingly, if an employee discloses material nonpublic information for his or her own benefit "in breach of a duty of trust or confidence to the issuer," the issuer would not be required to publicly disclose the information.

- Although the proposed Regulation relates to "material nonpublic information" it does not define "material". The Release states that it will rely on the standard definition of material generally used under federal securities laws. Under this definition 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."[2] In the Release the SEC states "... we believe issuers should avoid giving guidance or express warnings to analysts or selected investors about important upcoming earnings or sales figures; such earnings or sales figures will frequently have a significant impact on the issuer's stock price. At the other end of the spectrum, more generalized background information is less likely to be material."

- The Regulation only covers selective disclosure made to outsiders, such as analysts or investors. The public disclosure requirement would not be triggered by issuer disclosure to (i) "a person who owes a duty of trust or confidence to the issuer" such as attorneys, investment bankers or accountants, or (ii) a person who has expressly agreed to keep the information confidential.[3]

- Intentional disclosures of material nonpublic information must be publicly disclosed simultaneously, eradicating any intentional selective disclosure. A disclosure is

2. SEC Release Nos. 33-7787, 34-42259 (December 20, 1999) at 6 quoting TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

3. These people would still be subject to insider trading liability under Rule 10b-5 if the information was misused for trading.

intentional when "the individual making the disclosure either knew prior to making the disclosure, or was reckless in not knowing, that he or she would be communicating information that was material and nonpublic." 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. Unintentional disclosures must be publicly disclosed "as soon as reasonably practicable (but no later than 24 hours) after a senior official of the issuer knows (or is reckless in not knowing) of the non-intentional disclosure." The Rule defines senior official as any executive officer, director, investor relations officer, public relations officer or employee with equivalent functions.

- The "public disclosure" requirement of the Regulation can be satisfied by (i) filing a Form 8-K , (ii) issuing a press release through a widely circulated news or wire service such as Dow Jones, Bloomberg, Business Wire, PR Newswire or Reuters, or (iii) any other method that provides broad public access to the information and does not exclude any members of the public from access, such as a press conference which is open to the public through personal attendance or by telephonic or other electronic transmission.

- Issuers who do not comply with Regulation FD will be subject to a 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. Regulation FD is not an antifraud rule and will not subject an issuer to private liability. However, Regulation FD will not affect any existing basis of liability under the general antifraud rule, Rule 10b-5. The Regulation would apply to disclosure made by reporting issuers while they have pending registration statements for securities offerings. Accordingly, any statements of material information made at a road show would have to be publicly disclosed.[4]

If the Release is adopted it could have a significant impact on the way issuers interact with analysts. 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 or other information to analysts may 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 analysts

4. 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 release proposes a new Rule under the Securities Act that would not require such disclosure to satisfy the requirements of Section 10 of the Securities Act as long as it was made in compliance with Regulation FD. The Commission has requested comments as to whether this Rule should only apply to unintentional disclosure.

communications, including limiting which employees of the issuer can talk to analysts and what those employees can say.[5] Additionally, when an issuer has an analysts meeting or conference call or participates in an industry conference at which the issuer discloses nonpublic information, it may be required to issue a press release which includes the information disclosed contemporaneously with the event if the information disclosed is intentional or soon thereafter if the information disclosed is non-intentional.

INSIDER TRADING ISSUES

The Release addresses 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

Proposed Rule 10b5-1 aims to address the unsettled issue in insider trading law of whether to find a defendant liable it must be shown the defendant "used" the insider information he or she possessed in trading or it is enough to show that the defendant was in "knowing possession" of the information when he or she traded. Under the proposed Rule, as long as the trader "was aware of" the material nonpublic information when he or she made the trade it would be a sufficient basis for liability under Rule 10b-5. The Rule provides specific affirmative defenses against liability designed to cover situations in which a trade was executed under a pre-existing written plan, contract or instruction entered into in good faith. To fall under the defenses the trade must have been at the price, in the amount and on the date specified in such pre-existing plan, contract or instruction. An additional defense is provided for entities that trade in securities. The entity must show that (i) the individual responsible for the trade was not aware of the nonpublic information, and (ii) the entity had implemented reasonable policies and procedures, such as restricted lists and chinese walls, to prevent the flow of information that could cause insider trading.

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 of confidence required under the misappropriation theory. However, it has not been established under what circumstances certain non-business

5. Many issuers already have such procedures in place in an effort to avoid "entanglement" or insider trading liability under Rule 10b-5 of the Securities Exchange Act.

relationships such as family and personal relationships provide the duty of trust or confidence necessary under the misappropriation theory.

Proposed Rule 10b5-2 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 person communicating the material nonpublic information has a reasonable expectation that the other person would 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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If you have any questions concerning the Release, please contact Raymond Wagner, Vincent Pagano, Jr. or Jessica Gross, of this firm at (212) 455-2000.

SIMPSON THACHER & BARTLETT LLP