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## ARTICLES

### **Corporate Issuers Beware: *Schering-Plough* and Recent SEC Enforcement Actions Signal Vigorous Enforcement of Regulation FD**

JON JORDAN\*

#### I. INTRODUCTION

In September 2003, the United States Securities and Exchange Commission ("SEC" or "Commission") hit Schering-Plough and its chief executive officer with the largest civil penalties ever sought against a corporate issuer and its CEO for violations of Regulation FD.<sup>1</sup> The one-million dollar penalty against the corporation and fifty-thousand dollar penalty against the CEO, the first ever against an individual for violations of the regulation, were signals by the Commission under a new chairman, William Donaldson, that the regulation was here to stay and would be vigorously enforced. The Commission's position in *Schering-Plough* also stood in sharp contrast to the earlier years of Regulation FD's existence, when the regulation struggled to survive and was not aggressively enforced.

Enacted in 2000 to end the practice of selective disclosure, where

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\* Senior Counsel with the Southeast Regional Office of the United States Securities and Exchange Commission. The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues upon the staff of the Commission.

1. *Schering-Plough Corp.*, Exchange Act Release No. 48,461, Admin. Proceeding File No. 3-11,249 (Sept. 9, 2003); SEC Files Settled Regulation FD Charged Against Schering-Plough Corp. and its Former Chief Executive, Litigation Release No. 18,330, Case No. 1:03CV01880 (D.D.C.) (CKK) (Sept. 9, 2003).

issuers selectively disclose material nonpublic information to securities analysts and institutional investors, Regulation FD ran into powerful opposition by the securities industry against the backdrop of a grueling bear market for which some had considered the regulation partially to blame. The regulation overcame a strong opposition front, nearly leading to its modification or repeal, to eventually receive nearly unqualified support from an investment community wary of shady behind-the-scene deals in light of the Enron debacle and corporate scandals plaguing the marketplace. This allowed the SEC to move forward with its enforcement agenda in November 2002, when it filed a series of enforcement actions for violations of the regulation as part of a sweep. In the actions, the first of their kind concerning violations of the regulation, the Commission gave guidance on what it would look for in pursuing violators of the regulation and the actions signaled the Commission's willingness to enforce the rule. Soon thereafter, William Donaldson was named chairman of the SEC, and the investment community braced for a possible turning back of the rule. Donaldson and the Commission, however, moved forward with the Commission's enforcement program in the regulation in *Schering-Plough*. The case involved four times the civil monetary penalties as all of the sweep cases combined, and it was the first of its kind involving civil penalties against an individual.

This Article will trace the story of Regulation FD and the Commission's battle against the problematic issue of selective disclosure. The impact of the regulation, both positive and negative, will be explored as well as the calls for its modification or repeal during its infancy. I then will discuss the counter-resistance to calls for change to the regulation in light of corporate scandals in the marketplace. The Regulation FD enforcement sweep cases will then be laid out in detail, and their significance will be explained. The Article then will explore the controversy surrounding Donaldson's chairmanship of the SEC and its potential effect on the regulation. The *Schering-Plough* enforcement action that vitiated any concerns regarding the chairman's enforcement of the rule also will be examined. I next will address what I believe will happen to the regulation and future enforcement of it. Finally, I will recommend what corporations should do to avoid such SEC enforcement actions in the future.

## II. SELECTIVE DISCLOSURE

The Commission promulgated Regulation FD, standing for "Fair Disclosure," in 2000 as a result of Commission concerns about the prac-

tice of selective disclosure.<sup>2</sup> Selective disclosure generally refers to the practice in which issuers of securities “selectively provide material, non-public information to certain persons – often, securities analysts or institutional investors – before disclosing this same information to the public.”<sup>3</sup> While the practice of selective disclosure would appear to be a violation of the insider trading laws, the United States Supreme Court did not see it that way in *Dirks v. SEC*, a case involving an analyst who selectively disclosed nonpublic information received from a corporate insider.<sup>4</sup> Noting the important role of analysts in “ferret[ing] out and analyz[ing] information” of corporations, the Court in *Dirks* held that insider trading liability would arise only when an insider received a “personal benefit” from disclosing such information to an analyst.<sup>5</sup> The *Dirks* case was significant in that it hindered the Commission’s ability to pursue insider trading actions in selective disclosure matters, as it was difficult to prove the “personal benefit” nexus underlying any prohibited selective disclosure.<sup>6</sup> Nevertheless, despite the limitations imposed by *Dirks*, the Commission remained concerned about the problem of selec-

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2. See generally Regulation FD, 17 C.F.R. §§ 243.100-243.103 (2002); Selective Disclosure and Insider Trading, Exchange Act Release Nos. 34-43, 154 (Aug. 15, 2000) [hereinafter Approval Release].

3. See Regulation FD: Hearing Before the House Subcomm. on Capital Markets, Ins. and Gov’t Sponsored Enterprises, Comm. on Fin. Serv., 107th Cong. (2001) (written statement of the SEC [hereinafter SEC Statement to Congress]).

4. See *Dirks v. SEC*, 463 U.S. 646 (1983). In *Dirks*, an analyst at a New York broker-dealer received information from a former officer of a corporation primarily engaged in selling life insurance and mutual funds that the corporation’s assets were overstated as a result of fraudulent corporate practices. *Id.* at 648-49. The analyst discussed this information with a number of clients and investors, allowing those who held securities in the corporation to sell their holdings before the fraud became public and the stock’s value fell. *Id.* at 649-50. The Commission charged that the analyst was a “tippee” of the insider, the former officer, and that the analyst had in turn tipped his clients. *Id.* At the original hearing before an Administrative Law Judge, the judge had found that the analyst had aided and abetted violations of § 17(a) of the Securities Act of 1933 [hereinafter “Securities Act”], § 10(b) of the Securities Exchange Act of 1934 [hereinafter “Exchange Act”], and SEC Rule 10b-5. *Id.* at 650-51.

5. *Id.* at 663. The Court thus determined that the corporate insider did not breach a duty when he disclosed information to the analyst because the insider did not receive a personal benefit from the disclosure, but was motivated, instead, by a desire to expose a fraud. *Id.* And therefore, as the corporate insider had not breached a duty, the analyst in turn did not breach a duty when he passed along the same information to his clients, since a tippee’s duty is “derivative” from the duty of the tipper. *Id.* at 667. Consequently, the analyst was found not to have violated the insider trading laws under § 10(b) of the Exchange Act or Rule 10b-5 thereunder. *Id.* at 665-67.

6. See Selective Disclosure and Insider Trading, Proposed Rules, Exchange Act Release No. 33-7787, 64 Fed. Reg. 72,590 (Dec. 28, 1999) [hereinafter Proposed Rule]. Many saw the *Dirks* decision as providing protection to insiders who desired to make selective disclosures to analysts, as well as to the very analysts and their clients who received such selectively disclosed information. *Id.* Therefore, there were few insider trading cases based on trading related to disclosures made to securities analysts. *Id.*

tive disclosure.<sup>7</sup> In the face of growing reports that issuers were disclosing nonpublic information to selected securities analysts or institutional investors, the Commission began to focus attention on the problem, which Chairman Arthur Levitt referred to as a "stain" on the marketplace.<sup>8</sup>

Concerned that the practice of selective disclosure posed a "serious threat to investor confidence in the fairness and integrity" of the marketplace, the Commission tried to discern the best way to tackle, via a regulatory response, the issue of selective disclosure.<sup>9</sup> One of its options was to pursue a series of enforcement "test cases" by charging insider trading in matters involving selective disclosure with the hope of clarifying existing case law in the area.<sup>10</sup> But the difficult and often unpredictable strategy of "regulation by enforcement" was not viewed as necessarily the best weapon for tackling the problem, so the Commission decided to go with a rulemaking approach geared toward ending the problem.<sup>11</sup>

### III. REGULATION FD

The Commission's solution to the problem of selective disclosure came in the form of a novel regulation, Regulation FD.<sup>12</sup> In promulgating Regulation FD, the Commission went with an issuer disclosure rule for public companies, rather than directly combating the problem by treating selective disclosure as insider trading under the antifraud laws. While the goals of the regulation in promoting fair disclosure were honorable, the enactment and eventual adoption of the regulation did not occur without controversy. The Commission received an outpouring of public comments during the crafting of the regulation, both positive and

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7. See SEC Statement to Congress, *supra* note 3; Proposed Rule, *supra* note 6, at 72591-92; Approval Release, *supra* note 2, at 51717.

8. *Id.*; see also SEC Chairman Arthur Levitt, Remarks at the Economic Club of New York (Oct. 18, 1999). Chairman Levitt stated that the "behind-the-scenes feeding of material non-public information from companies to analyst" was a "stain" on the markets. *Id.* He felt that "[i]n a time when instantaneous and free flowing information is the norm, these sort of whispers" were "an insult to fair and public disclosure." *Id.* Chairman Levitt also expressed his disdain for selective disclosure in an earlier speech at the annual "SEC Speaks" conference in 1998 when he spoke about his concerns about an "increasingly worrisome form of trading" related to selective disclosure. See Chairman Arthur Levitt, "SEC Speaks" Conference (Feb. 27, 1998); see also Neal Lipschutz, *SEC Disclosure Rule Seeks Fairer Markets*, CHI. SUN-TIMES, Dec. 19, 1999, at B5 [hereinafter Lipschutz].

9. See Proposed Rule, *supra* note 6, at 72,592; SEC Statement to Congress, *supra* note 3.

10. See *id.* Such "regulation by enforcement" would have been used to fine-tune the *Dirks* decision toward the Commission's position. *Id.*

11. See *id.*

12. See generally Approval Release, *supra* note 2; Regulation FD, 17 C.F.R. §§ 243.100-243.103 (2002).

negative, which led to a substantially revised Regulation FD compared with its originally proposed form.<sup>13</sup>

### A. Approval of Regulation FD

On August 10, 2000, Regulation FD was officially adopted by the SEC.<sup>14</sup> Chairman Levitt praised the new regulation, noting that it would bring “all investors, regardless of the size of their holdings, into the information loop — where they belong.”<sup>15</sup> However, as expected, while

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13. See Approval Release, *supra* note 2, at 51717; Proposed Rule, *supra* note 6; News Release, SEC, SEC Proposes Rule to Ban Selective Disclosure of Material Information; Adopts Rules to Enhance Audit Comm. Effectiveness (Dec. 15, 1999); Ellen L. Rosen, *SEC Takes Aim at Disclosures*, NAT'L L. J., Dec. 27, 1999, at B1; Sandra Sugawara, *SEC Proposes Wider Disclosure; Analysts, Investors Would get Information at Same Time*, WASH. POST, Dec. 16, 1999, at E18. The proposed rule immediately received the blessing of individual investors. See Jeff Brown, *Market Players Must be Forced to Share Their Info with the Rest of Us*, PHILA. INQUIRER, Dec. 21, 1999, at K16-17; Lipschutz, *supra* note 8. It also received condemnation by many in the securities industry who had the most to lose from the new regulation. See Floyd Norris, *Wall Street Snarls at S.E.C. Proposal on Disclosure*, N.Y. TIMES, Dec. 16, 1999, at C16; Beth Piskora, *Stop the Whispers-Levitt*, N.Y. POST, Dec. 16, 1999, at 44. Of the nearly 6000 comment letters, the vast majority of the commenters were individual investors who expressed support for the regulation. See Approval Release, *supra* note 2, at 51717. These individual investors generally voiced frustration at the practice of selective disclosure because it put them at a disadvantage in the marketplace. *Id.* On the flip side, while most in the securities industry agreed that selective disclosure was inappropriate and generally supported the Commission's goals on promoting fairer disclosure, many expressed concerns about the approach the Commission was taking as a means for dealing with the issue. See Approval Release, *supra* note 2, at 51717; see also SEC Statement to Congress, *supra* note 3. One of the major concerns was that the regulation would have a “chilling” effect on issuer disclosure practices. See Approval Release, *supra* note 2, at 51717; see also SEC Statement to Congress, *supra* note 3. In response to these concerns, the Commission made significant changes to the proposed rule in order to narrow the regulation's scope and guard against any chilling effect. See Approval Release, *supra* note 2, at 51717; SEC Statement to Congress, *supra* note 3.

14. See generally Approval Release, *supra* note 2; Regulation FD, 17 C.F.R. §§ 243.100-243.103 (2002); see also Bill Alpert, *Fuller Disclosure: SEC Okays Rule to Ban Selective Leaks Without Curbing Enterprising Sleuths*, BARRON'S, Aug. 14, 2000, at 13; Fred Barbash, *SEC Strikes a Blow for 'Those Kept in Dark,'* WASH. POST, Aug. 20, 2000, at H6; Paul Bird & Paul Brusiloff, *SEC Passes Regulation FD but Heeds Its Critics*, INT'L FIN. LAW REV., Oct. 1, 2000, at 2325, available at 2000 WL 13894031; Dennis J. Black & Jonathan M. Hoff, *Regulation FD: New Rules for Selective Disclosure*, N.Y. L.J., Nov. 16, 2000, at 5; Danny Hakim, *SEC Approves Regulation Against Selective Disclosure*, N.Y. TIMES, Aug. 11, 2000, at C8.

15. See News Release, SEC, Comm. Votes to End Selective Disclosure; Chairman Arthur Levitt Hails Leveling of Info. Playing Field (Aug. 10, 2000). The Commission in the Approval Release stated that the regulation was designed to end the practice of selective disclosure and to maintain confidence in the integrity of the marketplace. See Approval Release, *supra* note 2, at 51716. In the Approval Release, the Commission stated that it had “become increasingly concerned about the selective disclosure of material information by issuers.” *Id.* The Commission added that it was concerned by recent reports that many issuers “were disclosing important nonpublic information, such as advance warnings or earnings results, to securities analysts or selected institutional investors, or both, before making full disclosure of the same information to the general public.” *Id.* As a result, the Commission was concerned that the “practice of selective disclosure leads to a loss of investor confidence” in the “integrity” of the

consumer groups and individual investors praised the enactment of the regulation,<sup>16</sup> the securities industry condemned it.<sup>17</sup> Publicly joining securities industry criticism of the regulation was Commissioner Laura Unger, who, in a rare dissent, publicly opposed the adoption of the regulation.<sup>18</sup> In a prelude of further dissent to come, Commissioner Unger expressed her opinion that the rule was "broader than the problem" and that corporate management would "not be sure" what was or was not material information considered prohibited selective disclosure under the new rule.<sup>19</sup>

### B. Regulation FD

Despite the controversy and extensive comments on the regulation, the regulation was enacted as a fairly straightforward rule. Regulation FD generally provides that "whenever an issuer," or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (generally securities professionals or holders of issuer securities who may trade on the basis of the information), that issuer must make public disclosure of that same information (1) simultaneously, in the case of an intentional disclosure; or (2) promptly, in the case of a non-intentional disclosure.<sup>20</sup> This general rule against selective disclosure is limited to disclosures made to the following categories of covered per-

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capital markets. *Id.* Another threat the Commission intended Regulation FD to address was "the potential for corporate management to treat material information as a commodity to be used to gain or maintain favor with particular analysts or investors." *Id.* at 51716-17. Noting that analysts "may feel pressured to report favorably about a company or otherwise slant their analysis in order to have continued access to selectively disclosed information," the Commission stressed that Regulation FD would prevent any backlash against analysts who publish negative views of an issuer as they could no longer be excluded by the issuer from calls and meetings to which other analysts may have been invited. *Id.* at 51717. The Commission also noted that selective disclosure "bears a close resemblance" to "ordinary 'tipping' and insider trading," but stated that "as a result of judicial interpretations, tipping and insider trading can be severely punished under the antifraud provisions of the federal securities laws, whereas the status of issuer selective disclosure" had been considerably "less clear." *Id.*

16. See *Fair Disclosure: SEC Rule Puts Small Investors in the Loop*, *NEWSDAY*, Aug. 11, 2000, at A54; Fred Barbash, *Thank SEC for 'Fair Disclosure'*, *WASH. POST*, Aug. 20, 2000, at H1.

17. See Bill Barnhardt, *Fair Disclosure Rule Dilutes Analyst Advantage*, *CHI. TRIB.*, Aug. 20, 2000, at C3; Thomas G. Donlan, *Editorial Commentary: Phony Fairness*, *BARRON'S*, Oct. 23, 2000, at 78; Beth Piskora, *Levitt Slammed for Fair Disclosure Rule*, *N.Y. POST*, Aug. 11, 2000, at 35; Ellen L. Rosen, *SEC's Fair Disclosure Rules Vex the Financial Community*, *N.Y. L.J.*, Aug. 23, 2000, at 1.

18. See *Reg. FD Could Swamp Investors, SEC's Unger Says*, *INVESTOR RELATIONS BUS.*, Aug. 14, 2000.

19. See *Selective Disclosure Rule Gains Approval by Divided SEC*, *SEC. REG. & L. REP.*, Aug. 14, 2000, at 1089-90 n.32 (quoting SEC Commissioner Laura Unger). Commissioner Unger was the sole Republican commissioner among Democrats at the time of the adoption of the regulation. *Id.*

20. See Regulation FD, 17 C.F.R. § 243.100 (2002); see also Approval Release, *supra* note 2, at 51719.

sons: (1) brokers or dealers; (2) investment advisers; (3) investment companies; and (4) holders of issuer securities where it is reasonably foreseeable that such persons will purchase or sell the issuer securities on the basis of the information.<sup>21</sup> There are four exclusions from coverage under the regulation.<sup>22</sup> The regulation will not apply to a disclosure made (1) to a person who owes the issuer a duty of trust or confidence (i.e. a temporary insider such as an attorney, investment banker, or accountant); (2) to a person who "expressly agrees" to maintain the information in confidence; (3) credit ratings organizations; and (4) in connection with most offerings of securities registered under the Securities Act.<sup>23</sup> Persons "acting on behalf of an issuer" under the regulation include "any senior official of the issuer" or "any other officer, employee, or agent of an issuer who regularly communicates" with any broker-dealer, investment adviser, investment company or with holders of the issuer's securities.<sup>24</sup>

A controversial component to the regulation is its application to disclosures of "material nonpublic" information.<sup>25</sup> While, the regulation itself does not define the terms "material" and "nonpublic," it relies on existing definitions of the terms "as established under case law."<sup>26</sup> In

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21. See Regulation FD, 17 C.F.R. § 243.100(b)(1) (2000). The first three categories include "sell side analysts, many buy side analysts, large institutional investment managers, and other market professionals who may be likely to trade on the basis of selectively disclosed information." *Id.* Approval Release, *supra* note 2, at 51719. Thus the regulation covers the types of persons "most likely to be the recipients of improper selective disclosure, but should not cover persons who are engaged in ordinary-course business communications with the issuer, or interfere with disclosures to the media or communications to government agencies." *Id.* at 51720.

22. See Regulation FD, 17 C.F.R. § 243.100(b)(2) (2000).

23. *Id.* The types of securities offerings under the regulation can be found under § 243.101(f). *Id.*

24. *Id.* § 243.101(c). The regulation is intended to cover "senior management, investor relations professionals, and others who regularly interact with securities market professionals or securities holders." See Approval Release, *supra* note 2, at 51720. A "senior official" means "any director, executive officer, . . . investor relations or public relations officer, or other person with similar functions." *Id.*

25. See Regulation FD, 17 C.F.R. § 243.100(a) (2000).

26. See Approval Release, *supra* note 2, at 51721. The Commission provided some guidance to the materiality issue when adopting the regulation by stating that information was deemed "material if 'there is a substantial likelihood that a reasonable shareholder would consider it important' in making an investment decision." *Id.* (citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). The Commission stated that in order "to fulfill the materiality requirement, 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.* The Commission also noted that "information is nonpublic if it has not been disseminated in a manner making it available to investors generally." *Id.* It is important to note that the use of the materiality standard in the regulation was the subject of many comments leading up to the adoption of the regulation. *Id.* Many commenters complained that the general case law definition of materiality would "cause difficulties for issuer compliance" and was "too unclear" a standard for issuers to use in making "real time" judgments about disclosures. *Id.* Such commenters



the Approval Release, the Commission provided a list of informational items that should be reviewed carefully for a determination as to whether they are material.<sup>27</sup> The Commission especially highlighted one common concern that involved "the practice of securities analysts seeking 'guidance' from issuers regarding earnings forecasts."<sup>28</sup> The Commission warned that "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."<sup>29</sup>

Another important aspect of the regulation deals with the timing of required public disclosure once a selective disclosure has been made. Such timing depends on whether the issuer has made an "intentional" or "non-intentional" selective disclosure.<sup>30</sup> A selective disclosure will be deemed "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."<sup>31</sup> When there has been an intentional selective disclosure, the issuer is required to publicly disclose the same information simultaneously.<sup>32</sup> If a selective disclosure has been made non-intentionally, disclosure of such information must be made "promptly."<sup>33</sup> The regulation defines "promptly" to mean "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

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preferred a bright-line standard of materiality so that materiality judgments could be made without difficulties. *Id.*

27. *See id.* Such items and events included: "(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 (e.g., the acquisition or loss of a contract); (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 — 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 (7) bankruptcies or receiverships." *Id.* The Commission, however, cautioned that "by including this list" it did "not mean to imply that each of these items" was "per se material." *Id.*

28. *Id.*

29. The Commission stated that "[i]f 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 analysts have been forecasting, the issuer likely will have violated Regulation FD." *Id.* The Commission further noted that this was "true whether the information about earnings is communicated expressly or through indirect 'guidance,' the meaning of which is apparent though implied." *Id.* An issuer cannot render "material information immaterial simply by breaking it into ostensibly non-material pieces." *Id.*

30. *See* Regulation FD, 17 C.F.R. § 243.100(a)(1)-(2) (2000); Approval Release, *supra* note 2, at 51722.

31. *Id.* § 243.101(a).

32. *See* Regulation FD, 17 C.F.R. § 243.100(a)(1) (2000). The regulation does not expressly define the term "simultaneously."

33. *Id.* § 243.100(a)(2).

Exchange)" after a senior official of the issuer has learned that there has been a non-intentional disclosure.<sup>34</sup>

Another important aspect of the regulation is the type of public disclosure that will satisfy its requirements once a selective disclosure has been made. Sufficient public disclosure under the regulation can be made by filing with the Commission a Form 8-K disclosing the selectively disclosed information.<sup>35</sup> Alternatively, public disclosure can be made by disseminating selectively disclosed 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."<sup>36</sup> The Commission provided guidance on the alternative methods of public disclosure that it will find acceptable, and these generally include the use of press releases, press conferences, and conference calls, either telephonically or through the Internet.<sup>37</sup> The intention of the alternative method of public disclosure provision was to give the issuer considerable flexibility in choosing the means of public disclosure.<sup>38</sup>

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34. *Id.* § 243.100(d). The regulation defines "promptly" to mean "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 . . . learns that there has been a non-intentional disclosure by the issuer or person acting on behalf of the issuer of information that the senior official knows, or is reckless in not knowing, is both material and nonpublic." *Id.*

35. *See id.* § 243.101(e)(1). Nevertheless, the Commission has stated that "either filing or furnishing information on Form 8-K solely to satisfy Regulation FD will not, by itself, be deemed an admission as to the materiality of the information." *See* Approval Release, *supra* note 2, at 51723.

36. Regulation FD, 17 C.F.R. § 243.101(e)(2) (2000).

37. *See* Approval Release, *supra* note 2, at 51723-24. Specifically, the Commission stated that such alternative methods of disclosure include "press releases distributed through a widely circulated news or wire service, or announcements made through press conferences or conference calls that interested members of the public may attend or listen to either in person, by telephonic transmission, or by other electronic transmission (including use of the Internet)." *Id.* The SEC stated that "the public must be given adequate notice of the conference or call and the means for accessing it." *Id.* at 51724. In noting the flexibility in the alternative methods of public disclosure, the Commission stated that "the regulation does not require use of a particular method, or establish a 'one size fits all' standard for disclosure; rather it leaves the decision to the issuer to choose methods that are reasonably calculated to make effective, broad, and non-exclusionary public disclosure, given the particular circumstances of that issuer." *Id.*

38. *See id.* As such, the regulation was intended to place responsibility on issuers to choose the "methods that are, in fact, 'reasonably designed' to effect a broad and non-exclusionary distribution of information to the public." *Id.* The Commission stated that "[i]n determining whether an issuer's method of making a particular disclosure was reasonable," it would "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." *Id.* A good example of this is the issuer's posting of new material information on its website. The Commission has cautioned that an "issuer's posting of new information on its own website would not by itself be considered a sufficient method of public disclosure." *Id.* However, it acknowledged that, "as technology evolves" and "more investors have access to and use the Internet," some issuers, "whose websites

In the Approval Release, the Commission explicitly stated that issuers that failed to comply with Regulation FD could be subject to an SEC enforcement action alleging violations of section 13(a) or 15(d) of the Exchange Act and Regulation FD.<sup>39</sup> The Commission also warned that, "in appropriate cases," it could also bring an enforcement action "against an individual at the issuer responsible for the violation, either as 'a cause of' the violation in a cease-and-desist proceeding, or as an aider and abetter of the violation in an injunctive action."<sup>40</sup>

#### IV. IMPACT OF REGULATION FD

The impact of the regulation on issuer disclosure and marketplace volatility has been a source of debate between proponents and opponents of the regulation since its enactment. While there was a short-term, and expected, impact felt in the marketplace as it adjusted to life under the new rule, opponents of the regulation complained of longer-term adverse unintended consequences of the rule.

##### A. Companies Strive to Comply with Regulation FD

As the October 23, 2000, effective date of the regulation approached, issuers, the securities industry and legal counsel strove to

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are widely followed by the investment community, could use such a method." *Id.* In the Approval Release, the Commission provided the following model, which it believed issuers could use for making a "planned disclosure of material information such as a scheduled earnings release." *Id.* "First, issue a press release, distributed through regular channels, containing the information; second, provide adequate notice, by a press release and/or website posting, of a scheduled conference call to discuss the announced results, giving investors both the time and date of the conference call, and instructions on how to access the call; and third, hold the conference call in an open manner, permitting investors to listen in either by telephonic means or through Internet webcasting." *Id.* The Commission stated that "[b]y following these steps, an issuer can use the press release to provide the initial broad distribution of the information, and then discuss its release with analysts in the subsequent conference call, without fear that if it should disclose additional material details related to the original disclosure it will be engaging in a selective disclosure of material information." *Id.*

39. See Approval Release, *supra* note 2, at 51726. The Commission noted that it could bring an administrative action seeking a cease-and-desist order, or a civil action seeking an injunction and/or civil money penalties. *Id.*

40. *Id.*; section 21C of the Exchange Act; 15 U.S.C. § 78u-3; section 20(e) of the Exchange Act, 15 U.S.C. § 78t(e). It is also important to note that recognizing "that the prospect of private liability for violations of Regulation FD could contribute to a 'chilling effect' on issuer communications," the regulation was crafted by the Commission to expressly provide that "no failure to make a public disclosure required solely" by Regulation FD "shall be deemed to be a violation of Rule 10b-5." Regulation FD, 17 C.F.R. § 240.102 (2000); Approval Release, *supra* note 2, at 51726. This provision was included in the regulation to make "clear" that "Regulation FD does not create a new duty for purposes of Rule 10b-5 liability" and therefore, "private plaintiffs cannot rely on an issuer's violations of Regulation FD as a basis for a private action alleging Rule 10b-5 violations. Approval Release, *supra* note 2, at 51726.

understand and prepare for compliance with the regulation.<sup>41</sup> One of the most immediate and profound effects of the regulation became an opening up of quarterly conference calls to individual investors.<sup>42</sup> This led to an innovation that allowed a broader dissemination of information than the traditional telephone conference call: the use of webcasts.<sup>43</sup> Another major effect of the regulation was that some corporations reduced or ended the one-on-one meetings they previously had with analysts.<sup>44</sup> Yet, despite these dramatic changes in corporate disclosure practices, uncertainty still prevailed among corporate issuers over the mechanics of complying with the regulation.<sup>45</sup>

In a couple of surveys of corporate issuers in the months following the effective date of the regulation, it became clear that most issuers were actively attempting to provide full and wide access to their earnings conference calls. In fact, a survey by Thomson Financial/Carson of publicly traded companies conducted in December 2000 found that

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41. See John Coffee, Jr., *Tackling New Reg. FD*, NAT'L L.J., Sept. 18, 2000, at B6; Paul A. Ferrillo, *Looking at New Regulation FD*, N.Y. L.J., Sept. 20, 2000, at 9; Robert Herz, *Learning to Live with Regulation FD*, SEC. WK., Oct. 2, 2000, at 8. Some in the industry went so far as to request an extension of the October 23, 2000, effective date, saying they needed more time to prepare for compliance with the rule. The National Investor Relations Institute (NIRI) asked the SEC to extend the effective start date of the regulation from October 23, 2000, to December 29, 2000, in order to give issuers additional time to prepare for compliance with the regulation. See Daniel Freed, *NIRI Requesting Extension on SEC Reg. FD*, WALL ST. LETTER, Sept. 25, 2000, at 1, available at 2000 WL 14647496. NIRI President Louis Thompson, who had been traveling across the country doing "roadshows" to educate issuers on compliance with Regulation FD, felt that ninety percent of the issuers would not be prepared for compliance by the October 23 effective date. *Id.* There also was an issue of the effective date's falling in the middle of many issuer's earnings cycles. *Id.* The Securities Industry Association (SIA) joined in the NIRI's request for an extension. See *NIRI, SIA Lobby SEC for Reg. FD Delay*, INVESTOR RELATIONS BUS., Oct. 9, 2000. The SEC disregarded these requests and on October 23, 2000, the public marketplace officially entered the Regulation FD world. See News Release, SEC, SEC Reaffirms October 23, 2000 Effective Date for Regulation FD (Oct. 12, 2000); *SEC Affirms Effective Date of Regulation FD*, SEC TODAY, Oct. 12, 2000, at 1; *SEC Rule on Sharing Corporate Data to go into Effect as Planned*, WALL ST. J., Oct. 13, 2000, at B2. On the eve of the effective date of Regulation FD, the SEC issued guidance in the regulation, in the form of a question-and-answer format, to help address outstanding issues and concerns in the marketplace concerning compliance with the regulation. See SEC, Div. of Corp. Fin.: Manual of Publicly Avail. Tel. Interpretations, Fourth Supp. (includes interpretations issued Oct. 2000, Dec. 2000, and May 2001); SEC Staff Releases Interpretive Guidance for Regulation FD, SEC Release 2000-159, Oct. 19, 2000; *SEC Issues Guidance on Regulation FD*, SEC TODAY, vol. 2000-203, Oct. 23, 2000, at 1.

42. See Jeff D. Opdyke, *Individuals Pick Up on Conference Calls*, WALL ST. J., Nov. 20, 2000, at C1. Such conference calls, where management generally gives its views on the company's performance and future prospects, traditionally had been open only to analysts and institutional investors. *Id.*

43. See Grace Delpit, *Webcasts May Replace Handshakes: Companies Find Ways to Cope in a Post-Reg. FD Environment*, INVESTOR RELATIONS BUS., Nov. 6, 2000, available at 2000 WL 8692710.

44. See *id.*

45. See Gregory J. Millman, *Reg. FD's Leveling Effect*, FIN. EXECUTIVE, Jan. 1, 2001, at 2936.

nearly half of the companies surveyed had changed the way they were disclosing information to analysts and investors in light of the regulation and that most companies were turning to their website and webcasting as a means of satisfying the regulation.<sup>46</sup> A survey by the National Investor Relations Institute (NIRI) found that a majority of companies had changed the way they were disclosing information, with eighty-nine percent of the public companies surveyed making earnings conference calls accessible to the public, mostly through Internet broadcast.<sup>47</sup> Interestingly, in contradiction to fears that Regulation FD would produce a "chilling effect" on issuer communications, forty-eight percent of the companies surveyed said they were disclosing the same amount of information to investors compared to before Regulation FD, with twenty-eight percent providing more information than before.<sup>48</sup> Even more surprising, seventy-four percent of the companies surveyed said they were conducting the same amount of one-on-one private conversations with analyst as they had before the regulation.<sup>49</sup>

Despite the initial confusion over the mechanics of complying with

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46. See *Regulation FD Aftermath: Winners and Losers Begin to Emerge*, PR NEWswire, Jan. 17, 2001 [hereinafter Thomson Survey I]. Nearly a third of the companies surveyed reported that they had limited the flow of information to analysts. *Id.* More than twenty-one percent of those surveyed said that they were no longer giving earnings guidance. *Id.* The survey results were based on responses from eighty-one companies. *Id.* Of the eighty percent of companies that made procedural changes on their disclosure practices in light of Regulation FD, a little over a third started webcasting their earnings conference calls and ninety-seven percent were publicizing access to the earnings call through press releases and their websites. *Id.* More than forty-one percent began to "simultaneously webcast their presentations at investment banking-sponsored conferences to the general investor community." *Id.* Some companies were declining to participate in such investment banking conferences unless they were allowed to do a live webcast of their presentations. *Id.*

47. See *Reg FD Study: Most Companies Still Generous with Info*, DOW JONES NEWS SERVICE, Feb. 26, 2001 [hereinafter NIRI Survey I]. This compares to only sixty percent providing such public access pre-Regulation FD. *Id.* Most companies were also ensuring that investors knew how they could tune in to upcoming conference calls: eighty-four percent were notifying investors through a news release, seventy-five percent were posting notices of such conference calls on their website and fifty-five percent were using "push technology" in sending out e-mail alerts. *Id.* According to the survey, seventy-nine percent of the companies were still providing some form of earnings guidance, with two-thirds providing such guidance in a news release and a third doing it through filing with the SEC. *Id.* More than half of those surveyed said they were updating their guidance in a news release when material facts or circumstances changed during the quarter. *Id.* The survey involved 577 companies of varying sizes, half listed on the New York Stock Exchange, half trading on Nasdaq. *Id.* NIRI is a professional association of corporate officers and investor relations consultants.

48. See *id.*

49. See *id.* Nevertheless, the NIRI stated that it did not study the quality of information being provided, which would later become a focal point regarding a possible adverse impact of the regulation. *Id.* For further analysis of the first NIRI Regulation FD survey, see Fred Barbash, *The Earthquake That Didn't Happen*, WASH. POST, Apr. 22, 2001, at H1; *NIRI Survey Assesses Results of New SEC 'FD' Regulation*, CAPITAL MARKETS REPORT, Feb. 26, 2001; *Road to Comfort with Regulation FD Remains Bumpy*, DOW JONES NEWS SERVICE, Mar. 6, 2001.

Regulation FD, corporate issuers eventually adjusted to the requirements. The use of webcasts became extremely popular as a means of compliance,<sup>50</sup> and most companies found a way to comply with the regulation by using a combination of webcasts and news releases to provide public access to conference calls.<sup>51</sup> These efforts by companies to comply with the regulation were recognized by numerous top officials at the SEC, who acknowledged that most companies were in good faith seeking to adhere to the regulation.<sup>52</sup>

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50. See Delpit, *supra* note 43; NIRI Survey I, *supra* note 47; Riva Richmond, *E-Business: Video Streaming is a Sleeper Hit with Business Crowd*, WALL ST. J., Aug. 20, 2001, at B6; Thomson Survey I, *supra* note 46. Webcasting has been deemed an essential and cost-effective way to reach the most investors. *Id.* Nevertheless, it should be cautioned that the use of webcasting by itself does not ensure complete compliance with Regulation FD. See *supra* note 37 and accompanying discussion. The late Commissioner Paul R. Carey, in testimony before Congress, warned that web-only disclosure should not supplant the disclosure of material information through a press release, given that computer ownership or web access was not yet universal, citing a recent Commerce Department survey that reported that (as of 2001) only 41.5 % of U.S. households had Internet access. See *Testimony Concerning Regulation Fair Disclosure Before the House Subcomm. on Capital Markets, Ins. and Gov't Sponsored Enterprises, Comm. on Fin. Serv.*, 107th Cong. (2001) (statement of Paul R. Carey, SEC Comm'r) [hereinafter Carey Congressional Testimony]. As such he viewed "the continuation of the earnings press release disclosure as transitional, but necessary, disclosure." *Id.*

51. A later survey by the NIRI, conducted in August 2001, verified that all companies had found a way to comply with the regulation by using webcasts and news releases to provide public access to conference calls. See *NIRI Gives SEC Broad Series of Recommendations for Improving Regulation Fair Disclosure; Based on Surveys and Other Input, NIRI Says Primary Objectives of Regulation FD are Being Met*, BUS. WIRE, Oct. 23, 2001 [hereinafter NIRI Survey II]. The NIRI reported that it submitted its recommendations in its second survey to the SEC in response to a request reportedly made by SEC Chairman Harvey Pitt. *Id.* The survey found that almost all companies (ninety-two percent) that were conducting conference calls were webcasting them for full access to the media and investors. *Id.* The remaining eight percent of companies were not conducting conference calls at all. *Id.* The survey also found that ninety-four percent of the companies surveyed were using news releases as a means of notifying the public of upcoming conference calls or other planned issuer presentations that would be webcast. *Id.* The survey also said that seventy-nine percent of the companies surveyed issued some form of earnings guidance. *Id.* This showed no change from the earlier NIRI survey. *Id.*; see also *supra* note 47 and accompanying discussion. It was somewhat surprising that the survey, like the earlier one by NIRI, found that only five percent of the responding companies had reduced the number of one-on-one private meetings with analysts and institutional investors, with most continuing to hold the same number or more meetings than they had held before Regulation FD became effective. *Id.* Another tool used by some companies to comply with the regulation included the increased use of confidentiality agreements with the analyst or institutional investor that the companies are providing information to. See Phyllis Plitch, *Companies' Widening Use of 'Gag' Option in Fair-Disclosure Rule Draws Criticism*, WALL ST. J., May 2, 2001, at C10. Some companies had also switched to monthly, as opposed to quarterly, reporting as a means of getting current information out into the marketplace. See Christopher Oster, *After Reg FD, Progressive Sets Bold Move*, WALL ST. J., May 11, 2001, at C1.

52. David Martin, the Director of the SEC's Division of Corporation Finance, said he was "very pleased" by what the Commission had been "seeing so far," noting that issuers were "making a big effort to get it right." See *Early Today: Businesses Adjusting to Life with Regulation FD, Which Requires Full Disclosure of News to Public* (CNBC television broadcast, Mar. 8, 2001), available at 2001 WL 22705810 (quoting SEC Division of Corporation Finance

## B. *Criticisms and Alleged Unintended Consequences of Regulation FD*

As issuers and the securities industry became comfortable with compliance with the regulation, criticisms concerning certain unintended adverse consequences of the rule began to surface. These criticisms would contribute to an opposition movement calling for modification or repeal of the regulation.

### 1. CHILLING EFFECT ON THE QUANTITY AND QUALITY OF INFORMATION

One of the primary fears in the crafting of the regulation involved a possible "chilling effect" the new rule might have on issuer disclosure.<sup>53</sup> The securities industry was concerned that issuers would hesitate to disclose corporate information, fearing that doing so would cause them to run afoul of the regulation.<sup>54</sup> The Commission recognized this concern and was careful to craft the regulation so as not to exacerbate it.<sup>55</sup> Nevertheless, as soon as the regulation became effective, many in the securities industry complained that issuers were becoming tight-lipped in regard to the kind of information that analysts had previously relied on in projecting earnings.<sup>56</sup> As surveys began to show that the quantity of information being provided by issuers had not necessarily decreased as a result of the regulation,<sup>57</sup> critics then began to argue that the quality, as opposed to quantity, of information had diminished as a result of the

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Director David Martin). Richard Walker, the Director of the SEC's Division of Enforcement, also noted that companies were "applying good faith and working hard to meet the requirements" of Regulation FD. See *SEC Believes Most Companies Try to Comply with Reg. FD*, SEC. REG. & L. REP., Apr. 23, 2001, at 586 n.16. Walker went on to say that "on balance" the regulation had been "very successful." *Id.*

53. Aaron Lucchetti & Christopher Oster, *Mum's the Word in Wake of Disclosure Rule*, WALL ST. J., Aug. 16, 2000, at C1.

54. *Id.*

55. See *supra* note 13 and accompanying discussion.

56. See Robert McGough & Robert Guy Matthews, *The Big Chill: Street Feels Effect of 'Fair Disclosure' Rule*, WALL ST. J., Oct. 23, 2000, at C1. There were some accounts of companies canceling one-on-one meetings with analysts. See Jeff D. Opdyke, *Wall Street Feels the Effect of 'Fair Disclosure' Regulation*, WALL ST. J.-EURO, Oct. 24, 2000, at 26. In a speech before the SIA on the impact of the regulation, Richard Walker, the SEC's Director of Enforcement at the time, expressed his belief that any chilling effect could have been the result of a temporary "overabundance of caution" on the part of issuers that were responding to "dire predictions" by some law firms that had opposed the regulation. See *Walker Addresses Enforcement Issuers Under New Regulation FD*, SEC TODAY, vol. 2000-213, Nov. 6, 2000, at 1 (quoting SEC Director of Enforcement Richard Walker).

57. See NIRI Survey I, *supra* note 47 and accompanying discussion, NIRI Survey II, *supra* note 51 and accompanying discussion; Thomson Survey I, *supra* note 46 and accompanying discussion; see also Cheryl Winokor Munk, *SEC Disclosure Rule Dims Appeal of Conferences*, WALL ST. J., Feb. 27, 2001, at C16.

regulation.<sup>58</sup> While some in the securities industry acknowledged that issuers were putting out the same or more information as before the regulation, they complained that the depth of nonmaterial information being provided was not the same as before the regulation.<sup>59</sup>

While the Commission expressed concerns about the possible chilling effect of the regulation,<sup>60</sup> many proponents of the rule felt that analysts and institutional investors were complaining simply because they no longer had access to the material nonpublic information they had had in the past.<sup>61</sup> Proponents of the regulation claimed that the rule was working just as it was intended in preventing the selective dissemination of material nonpublic information.<sup>62</sup>

## 2. LESS ACCURACY IN ANALYST FORECASTS

Another criticism of the regulation was that it resulted in less accurate forecasts by analysts.<sup>63</sup> Because analysts no longer had access to selectively disclosed earnings guidance from issuers, analysts' earnings estimates, which usually clustered around a tight predictable range, were

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58. *See id.*

59. *See id.* For many in the securities industry, both quantity and quality were issues. *Id.* In a survey released by the Association of Investment Management and Research (AIMR), fifty-seven percent of the analysts and portfolio managers surveyed said that the volume of substantive information released by issuers had decreased since the regulation. *See Analyst, Portfolio Managers Say Volume, Quality of Information Have Fallen Under Regulation FD*, AIMR Member Survey Shows, BUS. WIRE, Mar. 26, 2001. The same survey found that fifty-six percent of those surveyed felt that the quality of information disclosed had decreased as well. *Id.*; *see also* Judith Burns, *Analysts Report Loss Information in Wake of Regulation FD*, FEDERAL FILINGS NEWSWIRES, Mar. 26, 2001; Joel Chernoff, *Clamming Up: Reg FD Leads to Less Disclosure, not More*, PENSIONS & INVESTMENTS, Apr. 2, 2001, at 8; *Reg FD has Squelched Info Flow*, Survey Says, WALL ST. LETTER, Apr. 2, 2001, at 4.

60. *See* Isaac C. Hunt, Jr., *Emerging Issues under the Federal Securities Laws*, D.C. BAR CORPORATION, FINANCE & SECURITIES LAW SECTION (May 15, 2001). Commissioner Hunt said that "[c]oncerns remain . . . that Regulation FD may chill communications . . . [as many] [c]ompanies may choose not to disclose material information that before [they] had disclosed only to the analyst community." *Id.*

61. *See* Phyllis Plitch, *Reg FD Boosters Take Issue with Wall Street's Findings*, DOW JONES NEWS SERVICE, May 17, 2001.

62. *See id.* Harvey Goldschmid, the SEC's General Counsel who helped draft the regulation, said, "[T]here may be validity in analysts['] saying they're getting less information, but clearly some of that shortfall is of a kind the SEC properly meant to eliminate — hard-core material information." *Id.* (quoting SEC General Counsel Harvey Goldschmid). An academic study by the University of Southern California and Purdue University also found that the regulation had not harmed the flow of information to the markets. *See Regulation FD Does Not Harm Markets, Says USC Report*, BUS. WIRE, July 23, 2001. *See also infra* notes 124-29 and accompanying discussion; Phyllis Plitch, *Reg FD Study: The Regulation Has Not Harmed Flow of Info*, DOW JONES NEWS SERVICE, July 23, 2001.

63. *See* D. Casey Kobi, *Wall Street v. Main Street: The SEC's New Regulation FD and Its Impact on Market Participants*, 77 IND. L.J. 551, 588 (2002).



more widely dispersed than before the regulation.<sup>64</sup> As a result, the argument went, analysts' earnings predictions became less accurate.<sup>65</sup>

### 3. VOLATILITY

The greatest criticism of the regulation, and the hardest-felt in the marketplace, was that it led to greater volatility in the markets.<sup>66</sup> The argument went that there was a domino effect: A chilling in issuer disclosure resulted in less accurate analysts' earnings estimates, and thus more earnings surprises. The earnings surprises, in turn, led to greater volatility in the stock market when issuers' earnings numbers came out.<sup>67</sup> This increase in price fluctuations, it was argued, was a result of the surprise factor, coupled with the fact that everyone in the market could now react to disclosed information at the same time, as opposed when only the privileged few could preliminarily react.<sup>68</sup>

Volatility was one of the major concerns cited by Commissioner Unger in her dissent to adoption of the rule.<sup>69</sup> And long after adoption of the rule, many in the securities industry and the investing public continued to express concerns about the regulation's contribution to volatility.<sup>70</sup> While it is conceivable that the regulation may have had a short-term impact on volatility as issuers and the securities industry sought to

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64. See Robert McGough & Cassell Bryan-Low, *Analysts' Earnings Estimates Are Diverging, and SEC Disclosure Rule May Be the Reason*, WALL ST. J., Nov. 2, 2000, at C2. A study by BulldogResearch, a firm that tracks the performance of analysts in predicting earnings, found that analysts' estimates became more dispersed with a widening standard deviation centered around an average estimate. *Id.*

65. See *id.* The study found that the actual accuracy of the analyst's estimates decreased by 5.3%. *Id.* The study compared earnings estimates for companies that reported earnings in the second quarter of 2000 with earnings estimates of companies that reported third quarter earnings through October 24, 2000. *Id.*

66. See Thomas G. Donlan, *Phony Fairness: Reg. FD Will Hurt Markets and Investors*, BARRON'S, Oct. 23, 2000, at 8.

67. See Molly Williams & Robert McGough, *Intel's Jolt Shows Shifts in Market's Dynamics*, WALL ST. J., Sept. 25, 2000, at C1. In one of the first earnings surprises just prior to the effective date of Regulation FD, the effects of which was thought to have been contributed to by the impending regulation, Intel shocked the market by reporting weaker-than-expected revenue, causing its shares to drop twenty-two percent in one day. *Id.*

68. See Daniel Gross, *A Little Democracy on Wall Street*, N.Y. TIMES, Oct. 23, 2000, at A1. The stock market was perceived as being as "stable as an earthquake zone." *Id.*

69. See *infra* note 82 and accompanying discussion; see also SEC Acting Chairman Laura S. Unger, *Fallout from Regulation FD: Has the SEC Finally Cut the Tightrope?*, Remarks at the Glasser Legal Works Conference on SEC Regulation FD, New York, New York (Oct. 27, 2000), available at <http://www.sec.gov/news/speech/spch421.htm>. Noting the recent plunge in Intel's stock price by twenty-two percent in one day, Commissioner Unger felt that "[i]f increased volatility is one of the consequences of Regulation FD, then investors and their confidence in the marketplace could be damaged." *Id.*

70. See Len Boselovic, *Reg. FD Opens Door to Information, Critics*, PITTSBURGH POST-GAZETTE, Apr. 23, 2001, at B1; Jeff D. Opydyke, *How Much Are Stocks Hurting from Recent Rash of Profit Preannouncements Tied to New Rule?*, WALL ST. J., Mar. 2, 2001, at C1.

comply with the rule, it is disputable whether the regulation has had any long-term impact on volatility, since the marketplace has had the opportunity to adjust to the regulation's requirements.<sup>71</sup> Nevertheless, suspicions that the regulation contributed to volatility led to calls for, and nearly brought about, change in the regulation.<sup>72</sup>

#### 4. ANALYSTS WORKING HARDER

Another criticism of the regulation, and one met with little sympathy by individual investors, was that it forced analysts to work harder. Analysts, who had previously been privy to selective guidance by issuers, were now required to do more of the homework and legwork needed to actively project future earnings estimates.<sup>73</sup> While analysts found this particularly burdensome, many investors believed that forcing analysts to work and dig harder for information was not necessarily a bad thing. Rather, it caused many mutual fund companies to enhance their research capabilities into the companies they were investing in, placing less reliance on analysis provided by securities firms.<sup>74</sup> It also allowed the hardest working and best analysts to stand out, as their hard work, rather than

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71. There was some dispute as to whether the regulation had indeed increased volatility in share prices. It was reported that an internal SEC study on the regulation's effects on volatility found no discernible change in volatility since Regulation FD took effect. See Judith Burns, *SEC Study Finds No Impact on Market Volatility from Regulation FD*, DOW JONES NEWS SERVICE, Mar. 15, 2001. The study reportedly was requested by then Acting SEC Chairman Laura Unger over the objections of SEC economists. *Id.* A large-scale formal empirical study conducted by the University of Southern California and Purdue University also found no evidence of increased volatility as a result of the regulation. See *Regulation FD Does Not Harm Markets, Says USC Report*, *supra* note 62. "In fact, the evidence reveals a slight reduction in return volatility around earnings announcements since Regulation FD." *Id.*; see also Plitch, *supra* note 62. Furthermore, seventy-four percent of corporate leaders in a survey conducted by PricewaterhouseCoopers reported no impact from the regulation on the volatility of their respective companies' stock prices. See Neal Lipschutz, *Point of View: Corp. Execs Give Reg FD OK 1 Year Later*, DOW JONES NEWS SERVICE, Oct. 17, 2001. A little over six months after the effective date of the regulation, even then-Acting SEC Chairman Unger testified before Congress that it was impossible to draw any correlation between the regulation and market volatility. See *Testimony Concerning Regulation Fair Disclosure Before the House Subcomm. on Capital Markets, Ins., and Gov. Sponsored Enterprises, Comm. on Fin. Services*, 107th Cong. (2001) (statement of Laura S. Unger, SEC acting Chairman) [hereinafter Unger Congressional Testimony].

72. See Neal Lipschutz, *Point of View: Don't Blame Reg FD for Stocks' Fall*, DOW JONES NEWS SERVICE, Mar. 13, 2001. For a discussion of moves to reform the regulation in light of criticisms concerning, among other things, volatility, see *infra* notes 77-114 and accompanying discussion.

73. See Jeff D. Opdyke & Emily Nelson, *Conference-Call Crunch: New SEC Rule Turns Analysts' Rite Into a Hectic Affair*, WALL ST. J., Oct. 31, 2000, at C1; Kathleen Pender, *SEC's Regulation FD Should Force Analysts To Do Homework*, S.F. CHRON, Aug. 11, 2000, at B1; David Wells, *Analysts out in the Field Thanks to Disclosure Rule: Regulation FD Forces Emphasis on Anecdotal Research*, NAT'L POST, June 25, 2001, at C9.

74. See Allison Bishey Colter, *Fund Firms Strengthen Research Teams*, WALL ST. J., Jan. 2, 2001, at C19. Many mutual-fund companies beefed up their research departments in order to become less dependent on analysts. *Id.*

inside connections, set them apart from the rest of the pack.<sup>75</sup>

Despite the criticisms of chilling, less accuracy, volatility, and more work for analysts, many viewed these as minor costs compared to the benefits of the regulation. Nevertheless, all of these criticisms played a major role in securities industry efforts to overturn or severely weaken the regulation, as debate over the impact and harmful unintended consequences of the regulation began to intensify.<sup>76</sup>

## V. FOCUS TOWARD MODIFICATION OR REPEAL OF THE REGULATION

Soon after enactment of the regulation came an economic and political environment hostile to the rule. The bear market continued to worsen, with many blaming the regulation for exacerbating the decline, and a change into a more business-friendly Republican administration provided more power to traditional opponents of the rule. This led to a major refocus on the regulation, including public hearings before Congress. The future of the regulation was in jeopardy, even though it was only in its infancy.

### A. Scapegoat for Market Downturn

As the greatest bull market in history soured into bear territory after the adoption of Regulation FD, many asked whether the regulation itself was a cause of, or contributor to, the spiraling stock market.<sup>77</sup> The chil-

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75. See Jeff D. Opdyke, *Check Please: Some Stock Analysts Get Back to Basics in Wake of Scrutiny*, WALL ST. J., Sept. 5, 2001, at A1; Williams & McGough, *supra* note 67. One of the first analysts recognized for making the right call due to hard work was Ashok Kumar with US Bancorp Piper Jaffray, who downgraded shares of Intel to the anger and dismay of many money managers shortly before Intel shocked Wall Street with its revenue earnings shortfall that precipitated a twenty-two percent decline in the stock in one day. *Id.*

76. See *infra* notes 77-114 and accompanying discussion. One other criticism of the regulation not given as much focus within the Article, but which is still important to note, involves the regulation's effect on small issuers. Some small companies have complained that the regulation hampered their ability to attract analysts to their businesses. See *SEC May Tinker with Reg. FD: Disclosure Needs To Be More "Comfortable," Unger Says*, INVESTOR RELATIONS BUS., Apr. 30, 2001. As many smaller companies do not have the resources and the type of "fine-tuned disclosure practices in place to deal" with the regulation as their larger counterparts do, they are more concerned about running afoul of the regulation and find it more difficult to disclose certain information. Phyllis Plitch, *Reg FD Said to Add to Small Cos' Burden Wooing Analysts*, DOW JONES NEWS SERVICE, May 4, 2001. As a result, it can often be more difficult for an analyst to cover such small companies, with many analysts opting not to bother covering them at all. *Id.*; see also Steven Anderson, *Reg FD Proves to be a Nightmare for In-House Counsel*, CORPORATE LEGAL TIMES, Aug. 2001, at 57. Both Commissioners Hunt and Unger have voiced their concerns on the potential harsher effects the regulation may have had on issuers and promised to closely monitor the effect of the regulation on small issuers in contemplating possible future changes to the rule. See Rachel Witmer, *Unger Says SEC Will Monitor Reg FD; Too Soon to Assess its Effectiveness*, SEC. REG. & L. REP., May 21, 2001, at 753, 754.

77. See David Andelman, *Open Info Blamed: Stocks Hurt by Heavy Disclosure*, N.Y. DAILY NEWS, Mar. 10, 2001, at 41.

ling effect of the regulation and the volatility in share prices were thought by some to have contributed indirectly to the market's decline.<sup>78</sup> To make matters worse, the SEC's Acting Chairman under the incoming Bush government, Laura Unger, inflamed these suspicions by publicly claiming that there seemed "to be a correlation between the quality of information under" the regulation "and the drop in tech stocks."<sup>79</sup> This attention to the regulation as a source of negative influence on the stock market drew widespread scrutiny, as the stock market's decline impacted virtually all investors, large and small, and not just those in the securities industry.<sup>80</sup>

### B. Hostile Power Environment at the SEC

When Regulation FD was promulgated, Arthur Levitt headed up a Commission that was largely in favor of it. The lone dissenter at the time was Laura Unger, the sole Republican on a Commission with three Democrats.<sup>81</sup> While Unger was unable to prevent adoption of the regulation, she went on to criticize it and promised to monitor any unintended consequences it might have.<sup>82</sup>

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78. *See id.*

79. Neil Roland, *SEC Chief to Enforce Standard; Unger has Repeatedly Criticized Fair-Disclosure Rule*, WASH. POST, Mar. 16, 2001, at E3 (quoting Acting Chairman Laura Unger). Unger made the comment to a University of Cincinnati audience following a speech at the university. *See* SEC Acting Chairman Laura S. Unger, Raising Capital on the Internet, Remarks at the 2001 Corporate Law Symposium, University of Cincinnati School of Law (Mar. 9, 2001), available at 2001 WL 302824.

80. *See* Adelman, *supra* note 77. Nevertheless, some saw the advent of Regulation FD with the declining stock market as more of a coincidence than a causal relationship. *See* Lipschutz, *supra* note 72.

81. *See Selective Disclosure Rule Gains Approval by Divided SEC*, *supra* note 19, at 1089.

82. *See Regulation FD Could Swamp Investors, SEC's Unger Says*, INVESTOR RELATIONS BUS., Aug. 14, 2000, available at 2000 WL 8692594. At a speech only days after the October 23, 2000, effective date of the regulation, Commissioner Unger promised to be a "watchdog for any unintended consequences of Regulation FD." *See* SEC Acting Chairman Laura S. Unger, Fallout from Regulation FD: Has the SEC Finally Cut the Tightrope?, Remarks at the Glasser LegalWorks Conference on SEC Regulation FD, New York, N.Y. (Oct. 27, 2000) available at <http://www.sec.gov/news/speech/spch421.htm> [hereinafter Unger Oct. 27, 2000 Speech]. In the speech, she said she dissented from the adoption of the regulation because she: (1) thought the rule was unnecessary; (2) was concerned about issuers' scaling back on disclosure; and (3) was concerned about the quality of the information in light of the regulation. *Id.* As a watchdog for any unintended consequences of the regulation, she promised to (1) closely monitor studies by the SEC, SIA and others on the effectiveness of the regulation in reducing selective disclosure as well as the impact of the regulation in "chilling" of "corporate communications, market volatility and any disproportionate effect on smaller issuers;" (2) "[e]ncourage the staff and other commissioners to provide more guidance regarding the practices that are of concern to the Commission and those that are not;" (3) "[f]ind ways to facilitate 'public' dissemination of material nonpublic information through the Internet, and make sure that Regulation FD doesn't discourage the use of technology as a means of public dissemination;" and (4) "[s]crutinize staff recommendations on enforcement matters so that Regulation FD will be applied fairly and

Things changed with the election of George W. Bush, when a business-friendly Republican Party gained control of three of the five seats on the Commission, including the prized chairmanship. Soon thereafter, the regulation's biggest proponent, Levitt, resigned, leaving the regulation's biggest opponent, Unger, the next Acting Chairman.<sup>83</sup> In departing, Levitt warned that efforts might be undertaken to repeal the regulation.<sup>84</sup> So it came as little surprise that, upon Unger's taking over as Acting Chairman, she immediately began intensively focusing on the regulation and considering possible modifications or repeal of it.<sup>85</sup> In one of the first major initiatives by the very same commissioner who "bet [her] house" that the regulation would not work,<sup>86</sup> and who has been credited with joking that Regulation "FD" stood for "Flawed Disclosure,"<sup>87</sup> "Frequently Disregarded,"<sup>88</sup> "Fully Dysfunctional,"<sup>89</sup> and "Fundamentally Dumb,"<sup>90</sup> Unger announced plans to closely monitor the regulation and hold a public roundtable to discuss any adverse consequences it might have had.<sup>91</sup>

### C. Roundtable on Regulation FD

On April 24, 2001, in the heart of Wall Street, the SEC hosted a public roundtable discussion on Regulation FD moderated by Acting Chairman Unger ("Roundtable").<sup>92</sup> The public discussion was divided

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judiciously." *Id.*; see also Jeff Goldfarb, *Unger Pledges to Keep Close Watch on Regulation FD Effects*, SEC. REG. & L. REP., Nov. 6, 2000, at 1517.

83. See Floyd Norris, *Levitt to Leave the S.E.C. Early; Bush to Pick 4*, N.Y. TIMES, Dec. 21, 2000, at C1.

84. See *id.*

85. See What's New in the Land of Regulation?, Remarks by Acting Chairman Laura S. Unger, U.S. Securities and Exchange Commission, at the SEC Speaks in 2001, The Practising Law Institute, Washington D.C. (Mar. 2, 2001) [hereinafter Unger, Mar. 2, 2001, Speech]; Roland, *supra* note 79, at E3.

86. See Unger Oct. 27, 2000 Speech, *supra* note 82. In the speech, Unger said that "the Commission bet the store that Regulation FD would work . . . but I bet my house that it won't!" *Id.*

87. See Unger Congressional Testimony, *supra* note 71.

88. See Paul R. La Monica, *R.I.P., Reg FD? Some Companies Still Don't Know the Meaning of Fair Disclosure*, THE RED HERRING, June 1, 2001, at 80.

89. See *id.*

90. See *id.*; see also Business Adjusting to Life with Reg FD, Which Requires Full Disclosure of News to Public, CNBC: EARLY TODAY Mar. 8, 2001 (quoting Acting Chairman Laura Unger).

91. See Unger Mar. 2, 2001, Speech, *supra* note 85; see also Unger to Convene SEC Roundtables on Financial Portals, SEC. REG. & L. REP., Mar. 19, 2001, at 399.

92. In early April 2001, the SEC announced that it would be hosting a public roundtable discussion on Regulation FD to be moderated by Acting Chairman Unger. See SEC Announces Agenda and List of Participants for Regulation FD Roundtable, U.S. Securities and Exchange Commission News Release, SEC 01-35, Apr. 12, 2001. In the announcement Unger stated that she "expected[ed] a vigorous and enlightening dialogue that will provide [the Commission] . . . with a first hand look at how Regulation FD has impacted disclosure and changed the information landscape." *Id.* See also Judith Burns, *SEC's Unger Says Reg. FD Roundtable Is for 'Fact-*

into four categories of persons affected by the regulation: analysts, issuers, individual investors, and the press.

As expected, analysts at the Roundtable complained about the regulation, claiming it had a chilling effect on disclosure, which in turn hurt their ability to analyze relevant corporate data.<sup>93</sup> Issuers, on the other hand, expressed not so much opposition to the regulation, but confusion by it. The issuer panel noted a lack of consistency among their corporate legal departments on how to handle disclosure issues,<sup>94</sup> and recommended that the SEC provide more guidance on how companies should apply the rule.<sup>95</sup> On the opposite end of the spectrum from the analyst community was the panel of individual investors, who were happy with the regulation, as it provided them access to more information than they had ever had before.<sup>96</sup> The panel of representatives from the press also praised the regulation, as it opened to them valuable corporate information that they too had been shut out from.<sup>97</sup> While there were differing opinions concerning the consequences of the regulation, one opinion won a consensus: At only six months after the effective date, it was too early to judge the full impact of the regulation.<sup>98</sup> Nevertheless, Acting Chairman Unger and Commissioner Hunt both expressed a willingness to consider further guidance and possible modifications to the rule fur-

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*Finding,* DOW JONES NEWS SERVICE, Apr. 12, 2001. Unger opened the Roundtable by explaining that it was part of her commitment to monitor Regulation FD. See Acting Chairman Laura S. Unger, Opening Remarks at the SEC Roundtable Discussion on Regulation FD at the U.S. Securities & Exchange Commission, New York, N.Y. (Apr. 24, 2001), available at <http://www.sec.gov/news/speech/spch479.htm>.

93. See Carol Vinzant, *Brokerage Firms Target Disclosure Rule*, WASH. POST, Apr. 25, 2001, at E10.

94. See Jeff D. Opdyke, *Wall Street, SEC Discuss 'Reg FD' at Roundtable*, WALL ST. J., Apr. 25, 2001, at C16. The conflicting opinions of the legal departments had resulted in issuers' confusion and apprehension about the regulation. *Id.*

95. See Shanon D. Murray, *SEC Could Revisit Reg FD*, THE DAILY DEAL, Apr. 25, 2001.

96. See Neal Lipschutz, *Point of View: Reg FD Debate Heats Up, But Rule Works*, DOW JONES NEWS SERVICE, Apr. 27, 2001. One head of an individual investor organization claimed that he had not "met an individual investor who [was not] delighted with Regulation FD." *Id.* (quoting John Markese, President of the American Association of Individual Investors).

97. See *Reporters Give Reg. FD Thumbs Up*, INVESTOR RELATIONS BUS., Apr. 30, 2001. Floyd Norris, Chief Financial Correspondent for the *New York Times*, said that the regulation was a boon for journalists; before the regulation he had been "kicked out of conferences, lied to by companies and refused access to conference calls, which [had] meant [that he] had to rely on third-party information from analysts." *Id.*

98. See Jeffrey Goldfarb, *Industry Participants Want SEC to Issue Guidance on Regulation FD*, SEC. REG. & L. REP., Apr. 30, 2001, at 137. In fact, some urged the Commission to refrain from taking any action with respect to the regulation, at least until more could be learned through time. *Id.* This sentiment echoed a comment by Levitt only days before the Roundtable when, in a speech at UBS Warburg's Global Financial Services Conference, Levitt cautioned that it was too early to judge the regulation. See Chad Bray, *Former SEC Chairman: It's Too Early to Tell on Reg FD*, DOW JONES NEWS SERVICE, Apr. 23, 2001.

ther down the road.<sup>99</sup>

#### D. Congressional Hearings

Renewed industry and public focus on the regulation eventually led to congressional hearings on the rule.<sup>100</sup> Providing testimony before Congress on behalf of the SEC were Acting Chairman Unger, Commissioner Hunt, Commissioner Paul Carey (via written testimony), and the SEC itself.<sup>101</sup> Also included in the hearings were witnesses representing the securities industry and individual investors.<sup>102</sup>

At the hearing, Unger stressed several important factors and issues with respect to the regulation based on her findings at the Roundtable.<sup>103</sup> First and most important, she said, there was clear consensus in the marketplace that it was too soon to judge the effectiveness of the regulation.<sup>104</sup> Second, she stated that the regulation had increased the quantity of information provided by issuers, yet the regulation's impact on the quality of such information was still uncertain.<sup>105</sup> Third, she stressed that there was a need for more guidance on compliance with the regulation, especially insofar as how to deal with materiality issues.<sup>106</sup> Fourth, she noted that there was a need for more information dissemination tools that could be used to comply with the regulation.<sup>107</sup> Finally, she testified that the regulation could not be tied to volatility in the marketplace.<sup>108</sup> Commissioner Hunt echoed Unger's sentiments, saying it was too early to judge the effects of the regulation, and promising to closely

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99. See Phyllis Plitch, *SEC Eyes Regulation FD, Will Explore Further 'Guidance,'* DOW JONES NEWS SERVICE, Apr. 24, 2001. This included possible further guidance on the definition of materiality in the regulation or the issuance of "best practices" guidelines for the industry. *Id.*

100. See *Congress May Look into Reg. FD*, INVESTOR RELATIONS BUS., May 14, 2001; *SEC's Unger to Testify at Regulation FD Hearing Thursday*, DOW JONES NEWS SERVICE, May 15, 2001. Hearings on Regulation FD were officially conducted by the U.S. House of Representatives' Financial Services Committee's Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises. *Id.* Representative Richard Baker, Chairman of the subcommittee, stated that the hearings would focus on whether the rule was accomplishing its goals and whether it resulted in any unintended consequences involving a reduction in disclosure. *Id.*

101. See *id.*

102. See *id.* Among those testifying were witnesses representing the Securities Industry Association, the Motley Fool, and others in the securities industry. *Id.*

103. See Unger Congressional Testimony, *supra* note 71. Unger planned to issue a report on her findings from the Roundtable in the future. *Id.*

104. See *id.*

105. See *id.*

106. See *id.*

107. See *id.* Unger said that "the rules of the self-regulatory organizations, particularly the NYSE and NASD . . . limit the methods of dissemination otherwise allowed by Reg FD." *Id.*

108. See *id.* In concluding her testimony, Unger generally opined that more time was needed to assess the effectiveness of the regulation and promised that the SEC would continue to monitor the effects of the regulation. *Id.*

monitor the rule.<sup>109</sup> Commissioner Carey likewise voiced his opinion that it was too early to judge the impact of the regulation, but noted that he had seen “many positive signs” that the regulation was “working amazingly well.”<sup>110</sup>

The SIA and other critics of the rule testifying at the hearings were vehement about the need for changes in the regulation, some calling for further guidance, one even calling for abolishment of the rule altogether.<sup>111</sup> Individual investors and proponents of the rule, on the other hand, urged that the regulation remain intact and be stringently enforced.<sup>112</sup>

After hours of conflicting testimony, members of Congress said they were more confused than ever about the impact of the regulation.<sup>113</sup> Nevertheless, consensus among members generally coalesced around the SEC’s position that further study was needed before any changes in the rule should be undertaken.<sup>114</sup>

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109. See *Testimony Concerning Regulation Fair Disclosure, Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Comm. on Financial Services*, 107th Cong. (2001) (statement of Isaac C. Hunt, Commissioner, U.S. Securities and Exchange Commission) [hereinafter “Hunt Congressional Testimony”]. Hunt also testified that he remained concerned about the chilling effect of the regulation. *Id.*

110. See Carey Congressional Testimony, *supra* note 50. Carey did not appear at the hearing, but provided written testimony. *Id.*

111. See Judith Burns, *SEC Says Too Soon to Tell if Regulation FD Is a Success*, DOW JONES NEWS SERVICE, May 17, 2001. James Glassman, a resident fellow at the American Enterprise Institute, strongly felt that regulators should not “study it for two years” or attempt to modify it, but should simply “abolish it.” *Id.* The SIA submitted a survey it had conducted at the congressional hearing, which stressed that “69% of ‘sell-side’ analysts, those who produce buy and sell recommendations for brokerage firms, say Reg FD had adversely affected the advice they provide to clients.” Jeff D. Opdyke, *Rule of Fair Disclosure Hurts Analyst, House Subcommittee Is Told at Hearing*, WALL ST. J., May 18, 2001, at C15. The SIA sought modifications to the regulation that would “clarify materiality and protect analysts from liability.” See Burns, *supra* note 111. Sell-side analysts work for brokers and dealers who sell securities, while buy-side analysts typically work for mutual funds and pension funds that do in-house research. See Paula Span & Ben White, *The Market Scholars’ Star Turn, A Blurring of the Lines Produced Troubling Conflicts*, WASH. POST, Nov. 15, 2002, at A1, A18. The SIA survey was criticized by some investor groups, including some that said that the “SIA was extremely biased against FD and in favor of selective disclosure.” Phyllis Plitch, *Reg FD Boosters Take Issue with Wall Street’s Findings*, DOW JONES NEWS SERVICE, May 17, 2001 (quoting John Markese, President of the American Association of Individual Investors). David Becker, the SEC’s General Counsel, also criticized the SIA survey, noting that it contained the “subjective impressions” of analysts and stating that “as a serious analysis of the rule . . . it fails.” See Judith Burns, *SEC Official Says Too Early to Judge Regulation FD*, DOW JONES NEWS SERVICE, May 30, 2000.

112. *Id.* Individual investors and proponents of the rule were mainly represented by Thomas Gardner, co-founder of the Motley Fool. *Id.*

113. See Burns, *supra* note 111.

114. See *id.*; see also Witmer, *supra* note 76, at 753.



## VI. CORPORATE SCANDALS AND RENEWED SUPPORT FOR THE REGULATION

As calls for repeal or modification of the regulation began to intensify and become more of a real possibility under Unger's tenure as Acting Chairman, a counter-resistance to the regulation's opponents began to build. By the time the Enron scandal blew up, causing a massive loss of investor confidence in the marketplace, the rule had received nearly unqualified support from the investment community, and the analyst industry was powerless to resist it any further.

### A. Counter-Resistance in Support of the Regulation

The calls for change in the regulation stalled during congressional hearings just enough for the regulation's proponents to establish a front and fight back against those that sought to eliminate it.<sup>115</sup> The day after congressional hearings on the regulation, SEC Enforcement Director Richard Walker criticized the rush to judgment and disparaged the research sponsored by organizations that opposed the rule, calling it a "survey swamp" aimed at finding "more negative effects than positive effects" of the regulation.<sup>116</sup> The SEC's General Counsel, David Becker, likewise criticized the negative statements and surveys by opponents of the regulation.<sup>117</sup> As the public became aware of the opposition movement, many viewed it as simply an offensive by those in the securities industry who desired to turn back the clock to the old system of selective disclosure.<sup>118</sup> In the end, many criticized Unger for opening the debate on the regulation, feeling that any discussion of repeal or modification was grossly premature.<sup>119</sup>

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115. See Jeff D. Opdyke, *Rule of Fair Disclosure Hurts Analysts, House Subcommittee Is Told at Hearing*, WALL ST. J., May 18, 2001, at C15; Witmer, *supra* note 76.

116. Richard H. Walker, Director, Division of Enforcement, U.S. Securities and Exchange Commission, Remarks Before the Rocky Mountain Securities Conference (May 18, 2001). At the time Walker compared the "virtual stampede to declare" Regulation FD a "success or failure" to be "much like the networks' efforts to project a winner in a presidential election even before the polls have closed." *Id.* He said that "parties on all sides of the debate" were "rushing to publish studies, surveys, and purportedly objective analysis of FD, perhaps in the belief that whoever speaks first will gain an advantage in controlling future debate." *Id.*; see also *SEC Strikes Back at Reg. FD Surveys*, INVESTOR RELATIONS BUS., June 11, 2001.

117. See Burns, *supra* note 111. Becker particularly criticized the SIA's survey as simply "subjective impressions" by analysts concerning the rule. *Id.* He felt that "as a serious analysis of the rule," the survey "fails." *Id.*; see also Sara Hansard, *Says Reg. as Intended, Restricts Selective Disclosure: SEC Counsel Disputes SIA's Study on Reg FD*, INVESTMENT NEWS, June 11, 2001, at 12.

118. See La Monica, *supra* note 88, at 80.

119. See *Taking Sides — Regulation FD: Tinker with It, but Don't Toss It in the Trash*, INVESTMENT NEWS, June 4, 2001, at 10; David Moon, *Regulation FD Levels Playing Field for All Investors*, KNOXVILLE NEWS-SENTINEL, June 10, 2001, at D2; Jeff D. Opdyke & Michael

### B. *Change of Guard at SEC*

Against this backdrop of a growing counter-movement against changing the regulation, came the prospect of a changing of the guard at the SEC. When President Bush opted to appoint Harvey Pitt, instead of Unger, as the SEC's chair, the question remained whether Pitt would carry forward the securities industry's calls for change in the regulation.<sup>120</sup>

During his nomination hearings, Pitt, who had been critical of the rule while representing the securities industry in private practice, acknowledged familiarity with criticisms of the regulation and said that he felt that it was a rule that required "a closer look."<sup>121</sup> Nevertheless, he testified that he felt that the concept behind the rule was "unassailable,"<sup>122</sup> and favored awaiting the results of the Commission's monitoring of the regulation before coming to any conclusions as to how the regulation was working and whether anything needed to be done about it.<sup>123</sup>

### C. *Studies Refuting Alleged Adverse Impacts of the Regulation*

Three months after congressional hearings on the regulation, an independent academic study on the impact of the regulation found that the regulation had not caused harm to the marketplace.<sup>124</sup> The study, by the business schools at University of Southern California and Purdue University, was the first formal empirical study of the impact of the regulation, and it was not tainted by the sponsorship of any group with a vested interest in the regulation.<sup>125</sup> Sampling more than 1,500 compa-

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Schroeder, *Disclosure Rule Gets a Bad Rap*, WALL ST. J., June 5, 2001, at C1. Former Chairman Arthur Levitt thought the whole debate over the regulation was "absolutely premature." *Id.*

120. See Judith Burns, *Pitt Unlikely to Rescind Regulation FD*, ATTY DOTY SAYS, DOW JONES NEWS SERVICE, May 10, 2001.

121. Judith Burns, *SEC Nominee Pitt Promises Look at Decimals*, REGULATION FD, DOW JONES NEWS SERVICE, July 19, 2001. Harvey Pitt's past representation of numerous firms in the securities industry made individual investor groups nervous about the fate of the regulation once Pitt was confirmed. See Adam Levy, *U.S. Investors Ready to Fight to Retain FD: Individuals Fear Loss of SEC's Disclosure Rule*, NAT'L POST, Aug. 1, 2001, at D4. Such groups vowed to vehemently protest if the SEC tried to repeal or substantially weaken the regulation. *Id.* John Markese, President of the 180,000-member-strong American Association of Individual Investors, warned that, if such actions were taken, "you'll have people with pitchforks in the streets." *Id.*

122. Burns, *supra* note 121; see also Stephen Labaton, *S.E.C. Nominee Says Rules Need a Review*, N.Y. TIMES, July 20, 2001, at C1.

123. See Phyllis Diamond, *Pitt Concurs in Staff Views on 'Good Faith' Reg FD Compliance*, SEC. REG. & L. REP., Aug. 20, 2001, at 1206; see also Matthew Goldstein, *Happy Birthday Reg FD*, DOW JONES NEWS SERVICE, Oct. 23, 2001.

124. See *Regulation Does Not Harm Markets*, SAYS USC REPORT, BUS. WIRE, July 23, 2001 [hereinafter Academic Study].

125. See *id.*

nies, the researchers found no evidence of increased stock volatility centered around earnings announcements as a result of the regulation.<sup>126</sup> Likewise, the study found "no significant deterioration" in the performance of analysts' forecasts.<sup>127</sup> The only "significant effect" the researchers found was "almost a doubling of the number of voluntary earnings disclosures by managers."<sup>128</sup> The study delivered a strong blow to criticisms by the securities industry that Regulation FD had impaired corporate disclosure and increased volatility in the marketplace.<sup>129</sup>

Another significant survey with results favorable to Regulation FD was conducted by PricewaterhouseCoopers, which polled corporate issuers concerning their attitudes about the regulation.<sup>130</sup> Approximately ninety percent of the corporate leaders surveyed felt that Regulation FD should be continued, and that the regulation had increased or provided the same level of fairness compared to the way things were prior to the regulation.<sup>131</sup> With respect to the question of volatility, seventy-five percent of the issuers "reported no impact on their company's stock price" as a result of the regulation.<sup>132</sup> The survey was significant in that, a year after the enactment of the regulation, the entities responsible for compliance, corporate issuers, overwhelmingly accepted the rule and gave it high marks with respect to its fairness goals.<sup>133</sup> A month after

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126. See *id.* The evidence revealed "a slight reduction in return volatility around earnings announcements since Regulation FD." *Id.* The study involved a sampling of 1595 companies in which "researchers examined the quality of information reflected in both stock prices and various measures of analysts forecasting performance before and after implementation of Regulation FD." *Id.*

127. See *id.*

128. *Id.*

129. See *id.*; see also Phyllis Plitch, *Reg FD Study: The Regulation Has Not Harmed Flow of Info*, DOW JONES NEWS SERVICE, July 23, 2001. The study was scrutinized by the securities industry. Frank Fernandez, the chief economist at the SEC, said that the results seem "to run counter to what the conventional wisdom is." Phyllis Plitch, *Dire Effects of Disclosure Rule Doubt*, WALL ST. J., July 24, 2001, at C14; see also *Is Disclosure Rule a Non-Event? Reg. FD Has Not led to More Volatility, Study Says*, INVESTOR RELATIONS BUS., Aug. 6, 2001.

130. See *Regulation FD Significantly Improves Disclosure, Pricewaterhouse Survey Finds*, BUS. WIRE, Oct. 17, 2001 [hereinafter PwC Survey]. PricewaterhouseCoopers surveyed "leaders from 201 publicly held U.S. corporations on the impact of the first year of the regulation: 79 with large market cap (\$5 billion or more), 69 with a medium-size market cap (\$1-\$4.9 billion) and 53 with a small market cap (under \$1 billion)." *Id.* Interviewed were "120 VPs/Directors of Investor Relations, and 81 CFOs, controllers and Financial Managers." *Id.*

131. See *id.* While an overwhelming percentage of corporate leaders felt that the regulation should be continued, "sixty-eight percent said the SEC should issue specific guidelines about what information is 'material' to companies and requires disclosure, and what is not 'material'." *Id.* Only ten percent recommended repeal of the regulation. *Id.*

132. See *id.*

133. See Judith Burns, *Survey Finds SEC's Fair Disclosure Rule a Plus*, DOW JONES NEWS SERVICE, Oct. 17, 2002; Neal Lipschutz, *Point of View: Corp Execs Give Reg FD OK 1 Year Later*, DOW JONES NEWS SERVICE, Oct. 17, 2001. Despite the approval of the regulation by corporate issuers, the securities industry continued to complain that the regulation had hurt them.

the survey came out, Senator Paul Sarbanes, Chairman of the Senate Banking Committee and co-author of the Sarbanes-Oxley Act, expressed approval of the regulation and said he was encouraged by the results of the survey, which he felt "indicate[d] broadening acceptance of the rule, despite the initial controversy."<sup>134</sup>

#### D. Corporate Scandals

Overshadowing and eventually consuming the battle over the regulation, came the implosion of Enron and other corporate scandals, heightening the public's awareness and fears of corporate corruption.<sup>135</sup> Even before the scandals, Congress and the investing public had already begun to focus on shady conflict-of-interest issues within the analyst industry.<sup>136</sup> But once the corporate scandals broke out, whatever sympathy that might have existed for analysts' concerns about the regulation was diminished, ending any chance for substantial modification or repeal of the regulation.<sup>137</sup> Instead the public's distaste for corporate scandals and analyst conflict-of-interest issues led to wider acceptance of the regulation. By the time Commissioner Unger finally released her once-much-anticipated study on Regulation FD in December 2001, the movement for reform or repeal of the regulation was dead, and her recommendations were largely ignored.<sup>138</sup> And as calls for stricter enforce-

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Results from a survey conducted by the AIMR of financial analysts and portfolio managers released around the same time as the results from the PwC Survey found that a majority of those in the securities industry still felt that the quality and quantity of substantive information had declined as a result of the regulation. See *AIMR Survey Finds Reg FD Succeeding in Fairness Goal; Overall Disclosure Reduced*, SEC. REG. & L. REP., Oct. 18, 2001, at 1536 n.42; Lynn Cowan, *Disclosure Rule is Receiving Mixed Reviews*, WALL ST. J., Oct. 30, 2001, at B11; *Fair But Not Full Disclosure; Everyone Has Less Information Under Regulation FD, Analysts, Portfolio Managers Say in AIMR Survey; Analysts Ask for More Frequent Conference Calls, Earnings Updates*, BUS. WIRE, Oct. 18, 2001; Neal Lipschutz, *Point of View: Reg FD Survey Show No Shifts in Stance*, DOW JONES NEWS SERVICE, Oct. 18, 2001.

134. Rachel McTague, *Sarbanes Favors Reg FD; SEC Enforcement Standards*, SEC. REG. & L. REP., Nov. 19, 2001, at 1637 n.45.

135. Stephanie Anderson Forest & Wendy Zellner, *The Enron Debacle*, BUS. WK., Nov. 12, 2001, at 106; Daniel Kadlec, *Power Failure; As Enron Crashes, Angry Workers and Shareholders ask Where were the Firm's Directors? The Regulators? The Stock Analysts?*, TIME, Dec. 10, 2001, at 68; Daniel Kadlec, *Who's Accountable?: Inside the Growing Enron Scandal: How Evidence was Shredded and Top Executives Fished for a Bailout as the Company Imploded*, TIME, Jan. 21, 2002, at 28; see also Allan Sloan & Tamara Lipper, *Worldcom's Wrong Numbers; A Simple Math Trick may end up Dwarfing the Enron Scandal, and the Fallout is Only Beginning to Spread*, NEWSWEEK, July 8, 2002, at 44.

136. See Mark Hendrickson, *House Hearings Dim Chances for Reg FD Changes*, WALL STREET LETTER, Aug. 6, 2001, at 1.

137. *Id.*; Marcia Vickers & Mike France, *How Corrupt Is Wall Street?* BUS. WEEK, May 13, 2002, at 36.

138. See SEC Commissioner Laura S. Unger Releases Report, Recommends Improvements to Regulation FD, SEC News Digest, Dec. 6, 2001; see also COMMISSIONER LAURA S. UNGER, SPECIAL STUDY: REGULATION FAIR DISCLOSURE REVISITED (Dec. 2001). Commissioner Unger's

ment replaced calls for change in the rule, the Commission was able to proceed with the enforcement agenda required to provide a backbone to the regulation.

## VII. ENFORCEMENT OF REGULATION FD

### A. *Enforcement Warnings Prior to Regulation FD Sweep*

One of the biggest issues involving the regulation concerned how it would be enforced. For a long time, the corporate community was unsure whether the Commission would take an aggressive or lenient stance on enforcement of the regulation, and no corporation wanted to find out by being the first Regulation FD enforcement test case.<sup>139</sup> However, as corporations anxiously waited to see what enforcement stance the Commission would take, the SEC downplayed fears of over-aggressive enforcement of the regulation, reassuring the corporate community that it would not seek to punish those who sought to comply with the regulation in good faith. In one of his first speeches following the passage of the regulation, SEC Enforcement Director Richard Walker stated that there was “no need for fear or hysteria” for “Regulation FD was not designed as a trap for the unwary.”<sup>140</sup> He said the SEC was “not going to second-guess close calls regarding the materiality” of potential disclosures.<sup>141</sup> Walker’s position was reiterated by several other top

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report came as little surprise as she advocated many of the same points and recommendations she had previously expressed in her congressional testimony. *Id.* Among them, she recommended that the SEC provide more guidance on the definition of materiality as it applied to the regulation. *Id.* She also recommended that the SEC make it easier for issuers to use technology as a means for complying with the regulation. *Id.* Furthermore, she recommended that the Commission continue to study the quality of information that issuers were providing since the regulation, and, if the regulation had caused issuers to cut back on the quality of information, consider using its authority to encourage more disclosure. *Id.*; see also Floyd Norris, *S.E.C. Is Urged to Refine Rule on Disclosure*, N.Y. TIMES, Dec. 7, 2001, at C3; Michael Schroeder, *SEC Official Says Regulation FD Hasn’t Demonstrated Clear Impact*, WALL ST. J., Dec. 7, 2001, at C12.

139. This allegedly contributed to a short-term chilling effect in the disclosure of information as public issuers hunkered down and waited to see how the SEC would pursue potential violators of the regulation. See *supra* notes 53-62 and accompanying discussion on chilling effect.

140. Richard H. Walker, SEC Director, Division of Enforcement, Regulation FD: An Enforcement Perspective, Remarks at the Compliance & Legal Division of the Securities Industry Association, New York, N.Y. (Nov. 1, 2000) available at [www.sec.gov/news/speech/spch415.htm](http://www.sec.gov/news/speech/spch415.htm) [hereinafter Walker November 2001 Speech]. Walker said that “an issuer must have acted recklessly or intentionally in making a selective disclosure” for there to be a violation of the regulation. *Id.*

141. *Id.* Walker said that “[a]n issuer’s incorrect determination that information is not material must represent an ‘extreme departure’ from standards of reasonable care in order for [the SEC] to allege a violation of FD.” *Id.* The Director acknowledged the claims by some in the industry of a chilling effect, noting that “any such effect being observed [was] largely due to an overabundance of caution.” *Id.* He believed such an overabundance of caution was “fed by the dire predictions of numerous law firms and others opposed to the rule.” *Id.* He added that the SEC Enforcement Division would not be “second-guessing reasonable disclosure decisions made in good faith” nor

SEC officials.<sup>142</sup> Despite his reassuring words, Walker did caution that the Enforcement Division would not be a “toothless tiger” in enforcement of the rule.<sup>143</sup> He warned that the SEC would be on the lookout for two types of violations.<sup>144</sup> The first type would concern “egregious violations involving the intentional or reckless disclosure of information that is unquestionably material.”<sup>145</sup> The second type would involve those “who deliberately attempt to game the system either by speaking

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was the SEC “looking to test the outer limits of the rule by bringing cases that aggressively challenge the choices issuers are entitled to make regarding the manner in which a disclosure is made.” *Id.* He said there would be no “FD Swat teams” and he did not envision any “FD sweeps” in the absence of widespread noncompliance with the regulation. *Id.*

142. Director Walker’s position on enforcement of the regulation was soon corroborated by other high-ranking officials at the SEC. A day after Walker’s speech, David Martin, the SEC’s Director of the Division of Corporation Finance, stressed that the SEC would not be seeking to enforce the regulation in “close cases.” See Rachel Witmer, *SEC’s Martin Tells Law Gathering Reg FD Enforcement Not for ‘Close Cases,’* SEC. REG. & L. REP., Feb. 13, 2000, at 1546, 1547 (quoting SEC Director of Corporation Finance David Martin). Martin said “[t]he enforcement division” was “not looking for close cases” and that no one would be “splitting hairs.” *Id.* at 1547. Martin made the comments on November 2, 2000, during a speech at a Practising Law Institute conference on securities regulation in New York. *Id.* And at the SEC’s Roundtable, Commissioners Hunt and Unger both stressed that the SEC would not be overly aggressive in enforcement of the rule. See Jeffrey Goldfarb, *Industry Participants Want SEC to Issue Guidance on Regulation FD,* SEC. REG. & L. REP., Apr. 30, 2001, at 637; see also Phyllis Plitch, *SEC Eyes Regulation FD, Will Explore Further ‘Guidance,’* DOW JONES NEW SERVICE, Apr. 24, 2001. Commissioner Hunt said the SEC would be “very cautious in the way” the regulation would be enforced. *Id.* He also noted his concern that there was a “feeling among companies that they have to be overly cautious” or else the SEC “will get them.” See Murray, *supra* note 95. Less than a month after the Roundtable, the two commissioners, along with Commissioner Carey, reiterated the benign enforcement stance in congressional hearings on the regulation. See *supra* notes 100-10 and accompanying discussion. Commissioner Hunt, noting that the SEC was not necessarily “looking for a test case,” said that he would not “personally support an enforcement action in a case that [he] did not find to be egregious.” See Hunt Congressional Testimony, *supra* note 109. Commissioner Carey echoed Director Walker’s sentiments that the “Commission does not intend to bring an enforcement action against an issuer who is making a good faith reasonable effort to comply with the rule.” See Carey Congressional Testimony, *supra* note 50. He then said he “would be very reluctant to support an FD enforcement action based on a mere technical violation where an issuer made a good faith, reasonable attempt at compliance.” *Id.* Incoming SEC Chairman Harvey Pitt, in response to questions posed at his confirmation hearing, also voiced his concurrence with the enforcement staff’s approach in not attempting to “second-guess reasonable, good faith judgment by persons who honestly attempt to comply” with the regulation. See Phyllis Diamond, *Pitt Concurs in Staff Views on ‘Good Faith’ Reg FD Compliance,* SEC. REG. & L. REP., Aug. 20, 2001, at 1206. Pitt made his statements in written responses to questions posed by Senator Susan Collins of Maine at Pitt’s confirmation hearing. *Id.*

143. See Walker November 2001 Speech, *supra* note 140.

144. See *id.*

145. *Id.* This type “includes the selective disclosure of information regarding mergers or acquisitions, earnings, or other matters that the courts or the Commission have long held to be material.” *Id.* He then said that the regulation’s Approval Release “spells out seven items that should be reviewed carefully to determine whether they are material: earnings information; mergers and acquisitions; new products or developments regarding customers and suppliers; changes in control or management; change in auditors; a default or calling of securities; and bankruptcies.” *Id.*; see also *supra* note 27 and accompanying discussion.

in code, or stepping over the line again and again, thus diminishing the credibility of a claim that their disclosures were non-intentional.”<sup>146</sup>

Despite attempts by SEC officials to ease the corporate community's fears about the Commission's enforcement of the regulation, there were signs that the SEC was growing wary of prohibited corporate conduct that was continuing after the regulation. Months after the regulation was enacted, it became apparent that the SEC had several confidential investigations into potential violations under way.<sup>147</sup> Then in March 2001, the press reported on two specific SEC investigations involving Raytheon and Motorola.<sup>148</sup> Soon thereafter, in a May 2001 speech, Enforcement Director Walker warned again that he was disturbed by continuing selective disclosure practices.<sup>149</sup> And as the corpo-

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146. *Id.* Walker said information could not come in a “coded response calculated to convey indirectly information that cannot be disclosed directly.” *Id.* He also cautioned that the SEC would be on the lookout for “situations involving multiple violations that an issuer claims were non-intentional,” noting that such a pattern would “surely . . . raise questions as to whether these were truly innocent slips.” *Id.* Overall, Walker's speech was designed to provide a level of comfort that the SEC would be reasonable in its enforcement of the regulation. *Id.*; see also *Walker Addresses Enforcement Issues Under New Regulation FD*, SEC TODAY, vol. 2000-213, Nov. 6, 2000; Richard Hill, *SEC Enforcement Chief Tells SIA New Fair Disclosure Rules Target Issuers*, SEC. REG. & L. REP., Nov. 6, 2000, at 1517; *Head of SEC Enforcement Division Comments on Regulation FD*, ANDREWS SEC. LITIG. & REG. REP., Dec. 6, 2000.

147. See *SEC Probes Possible Fair Disclosure Violations*, L.A. TIMES, Mar. 16, 2001, at C5. Stephen Cutler, then Deputy Director of the SEC's Enforcement Division, in March 2001, said there were “about half a dozen situations” that the Division was “currently looking at” involving potential violations of the regulation. *Id.*

148. Michael Schroeder, *Raytheon's Disclosure to Analysts Is Investigated*, WALL ST. J., Mar. 15, 2001, at A3. Raytheon and Motorola declined to comment on the probes. *Id.*; see also *SEC Probes Possible Fair Disclosure Violations*, L.A. TIMES, Mar. 16, 2001, at C5; Neil Roland, *SEC Chief to Enforce Standard; Unger Has Repeatedly Criticized Fair-Disclosure Rule*, WASH. POST, Mar. 16, 2001, at E3.

149. See Richard H. Walker, Director, Division of Enforcement, Remarks Before the Rocky Mountain Securities Conference, Denver, Colorado (May 18, 2001). In the speech, Walker reiterated that Regulation FD was not designed as a trap for the unwary and that the enforcement staff would only pursue “clear-cut” violations of the regulation. *Id.* Nevertheless, he did say he was troubled by evidence suggesting that conduct by some issuers had not changed, even though seven months had passed since enactment of the regulation. *Id.* He compared what he should be seeing to that of an advertisement for a diet shake. *Id.* “Just like in the advertisements for those amazing diet shakes, we should see a marked difference between the ‘before’ picture and the ‘after’ picture.” *Id.* He added that “[u]nfortunately, this is not always the case.” *Id.* Walker said he still “read of top corporate officials calling multiple analysts to review prior announcements, resulting in the analysts lowering their earnings estimates.” *Id.* He also had heard of senior officers making calls to analysts and “talking them down from their earlier assumptions.” *Id.* He said he had learned of “senior officials who, late in the quarter, confirm to a single analyst guidance given publicly months earlier when market conditions were very different.” *Id.* These kinds of stories, he said, would “almost certainly trigger an enforcement inquiry.” *Id.* He also said the Enforcement Division was “currently looking at fewer than ten situations involving potential FD violations.” *Id.* Walker stressed that “[t]wo constituencies that strongly supported adoption of Regulation FD — individual investors and the press — have emerged as energetic watchdogs for potential violations of the rule.” *Id.* For more on Walker's May 2001 speech, see

rate community braced for the outcome of the SEC's probes of Raytheon and Motorola, and possibly others, one thing was certain — enforcement action by the SEC was imminent.<sup>150</sup>

### B. Regulation FD Sweep

On November 25, 2002, the SEC brought four actions for violations of Regulation FD. These actions, part of a sweep, made a strong statement to the public that Regulation FD would be enforced and that violations would not be tolerated.<sup>151</sup>

#### 1. IN THE MATTER OF RAYTHEON COMPANY AND FRANKLYN A. CAINE

As expected, given press reports of the underlying investigation, the SEC instituted and settled administrative cease and desist proceedings against Raytheon and its Chief Financial Officer, Franklyn A. Caine.<sup>152</sup> The action involved violations of the regulation by Raytheon,

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*Walker Outlines Enforcement Effort as SEC Watches for Reg FD Violators*, SEC. REG. & L. REP., June 4, 2001, at 826. It is important to note that two weeks after Walker's words of caution, SEC General Counsel David Becker promised that the SEC would bring cases against companies that it believes violated the rule. See Burns, *supra* note 111. Becker promised the SEC "will bring cases" against companies violating the regulation. *Id.*

150. See *Motorola's Talks with Analysts Examined*, N.Y. TIMES, Mar. 30, 2001, at C12; John Labate, *SEC Launches Probes into Disclosure Violations: U.S. Regulators Still Seek First Reg FD Transgression*, NAT'L POST, Apr. 8, 2002, at FD3; Phyllis Plitch, *Motorola Says Private Discussions with Analysts Aren't Material*, WALL ST. J., Aug. 24, 2001, at B2. Some reports suggested that the prospect of an enforcement action became even more likely when the SEC began to come under fire amid the corporate scandals involving Enron and WorldCom. See Anne Marie Squeo, *Raytheon May Settle with SEC in Disclosure Case*, WALL ST. J., July 17, 2002, at B9.

151. The SEC did not formally label the actions a "sweep," a term commonly used by the Enforcement Division for a large number of simultaneously filed enforcement actions related to similar violations, but the actions could be seen as a sweep since they were brought at the same time, involved alleged violations of the same regulation, and sent a strong message. This is particularly true in light of the fact that there were no Regulation FD cases prior to the sweep. See Press Release, U.S. Securities and Exchange Commission, SEC Charges 41 People in 13 Actions Involving More Than \$25 Million in Microcap Fraud (Sept. 24, 1998), available at [www.sec.gov/news/press/pressarchive/1998/98-92.txt](http://www.sec.gov/news/press/pressarchive/1998/98-92.txt); Press Release, U.S. Securities and Exchange Commission, SEC Charges 44 Stock Promoters in First Internet Securities Fraud Sweep (Oct. 28, 1998); Press Release, U.S. Securities and Exchange Commission, SEC Charges 82 Individuals and Companies in 26 Actions Involving More Than \$12 Million in Second Nationwide Microcap Fraud Sweep (Aug. 3, 1999); Press Release, U.S. Securities and Exchange Commission, SEC Charges 68 Individuals and Entities with Fraud and/or Abuses of the Financial Reporting Process (Sept. 28, 1999); Press Release, U.S. Securities and Exchange Commission, SEC, State Securities Regulators Announce Promissory Note Enforcement Sweep (June 1, 2000); and Press Release, U.S. Securities and Exchange Commission, SEC Charges 23 Companies and Individuals in Cases Involving Broad Spectrum of Internet Securities Fraud (Mar. 1, 2001).

152. *In the Matter of Raytheon Company and Franklyn A. Caine*, Exchange Act Release No. 46897 (Nov. 25, 2002). In anticipation of the public cease-and-desist proceedings, Raytheon and the CFO each submitted an offer of settlement, which the Commission accepted. *Id.* Without admitting or denying the findings set forth within, Raytheon and the CFO consented to the entry



through its CFO, after the CFO selectively provided earnings guidance to sell-side equity analysts covering the company.<sup>153</sup> After a February 7, 2001, investor conference call, in which Raytheon reiterated annual earnings-per-share guidance but did not provide quarterly earnings-per-share guidance, the CFO directed his staff to contact sell-side analysts covering the company and request copies of the analysts' quarterly models for the company.<sup>154</sup> The CFO then arranged and conducted one-on-one calls with the analysts, generally communicating that their first quarter earnings-per-share estimates were too high, and specifically informing some of them that their estimates were either "too high," "aggressive," or "very aggressive."<sup>155</sup> As a result of the calls, the analysts subsequently revised their earnings estimates for the first quarter, the consensus of which Raytheon subsequently beat by a penny per share when it reported its actual first quarter earnings.<sup>156</sup>

In bringing the action, the Commission stressed that the CFO selectively disclosed earnings guidance, the "prototypical disclosures Regulation FD aimed to prohibit."<sup>157</sup> The Commission stated that "one of the primary purposes of Regulation FD was to prohibit the issuer practice of selectively providing guidance to securities analysts regarding earnings forecasts,"<sup>158</sup> and found that the company's disclosures to analysts were material because, among other things, the subject matter of the informa-

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of the Order Instituting Public Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934. *Id.*

153. *Id.*

154. *Id.* The CFO directed his staff to contact each sell-side analyst whose estimates were included in Thomson Corporation's First Call Service. *Id.*

155. *Id.* From mid-February to early March, the CFO had one-on-one calls with eleven of thirteen sell-side analysts who were covering Raytheon stock and "whose estimates were part of the consensus estimate maintained by First Call." *Id.* Raytheon had yet to provide public quarterly earnings guidance for 2001, and the CFO knew that the analysts' first quarter 2001 EPS estimates exceeded Raytheon's own internal estimate, and "that the analysts' 2001 quarterly earnings estimates reflected a less seasonal quarterly distribution than 2000 results." *Id.* During the one-on-one calls, the CFO told the analysts that Raytheon's earnings for 2001 would likely have the same seasonal distribution as in 2000, and that "Raytheon would generate one-third of its EPS in the first half of the year and remaining two-thirds in the second half of the year." *Id.*

156. *See id.* By mid March 2001, after the CFO's calls, the 2001 first quarter earnings per share consensus had dropped from thirty-one cents to twenty-seven cents per share, a penny below Raytheon's internal forecast. *Id.* The Street's first quarter earnings per share consensus of twenty-seven cents stayed the same until Raytheon reported first quarter earnings per share of twenty-eight cents in April 2001. *Id.* In a public conference call moderated by the CFO discussing Raytheon's first quarter results, the company stated that it was "pleased to report another quarter of progress toward our goal of restoring your confidence in our company" and that the quarter represented "the fifth straight quarter we have met or exceeded our commitments to you." *Id.*

157. *Id.*

158. *Id.* The order then cited the portion of the Approval Release that warned that providing direct or indirect guidance could result in violation of the regulation. *Id.*; *see also supra* notes 28-29 and accompanying discussion.

tion related to earnings guidance.<sup>159</sup> As the selective disclosures were made intentionally within the meaning of the regulation, Raytheon was required to make simultaneous public disclosure of the relevant information, which it had failed to do, thus violating the regulation.<sup>160</sup>

The order mandated that Raytheon and the CFO cease and desist from committing or causing any violations of the securities laws that they were found to have violated.<sup>161</sup> There were no further sanctions besides the cease-and-desist remedy. Commissioner Campos dissented from the order because of the lack of a penalty.<sup>162</sup>

#### SIGNIFICANCE OF CASE

The Commission clearly signaled that it would not tolerate the practice of issuers selectively disclosing earnings guidance to analysts. In noting that this was the “prototypical” type of disclosure that the regulation had aimed to prohibit, the SEC stressed that such earnings guidance, when selectively disseminated, would clearly run afoul of the regulation.<sup>163</sup> Thus, the case provided the Commission an opportunity to reiterate the intent of the regulation: to prohibit issuers from selectively disclosing earnings guidance to analysts.<sup>164</sup>

A disturbing revelation in *Raytheon* was that the CFO of a New York Stock Exchange listed company conducted one-on-one calls and provided the very type of earnings guidance to analysts that the regulation was designed to prohibit. His conduct was in blatant disregard of the regulation and was, in my view, probably the most heinous among the four sweep cases brought by the Commission. Given this extreme departure from compliance with the regulation, one has to ask why a civil penalty was not sought. Commissioner Campos’s dissent shows

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159. *See id.* The Commission found Raytheon’s disclosures to analysts to be material “by reason of (1) the subject matter of the information, i.e., earnings guidance,” (2) the CFO’s conduct in “reaching out to each analyst to deliver the same message, (3) the consistent reaction of the analysts to lower their first quarter estimates after receiving Raytheon’s guidance, (4) the decision of two analysts to announce the lowering of their first quarter estimates in calls to their firms’ sales forces, and (5) the e-mails sent by one firm’s sales force following an analyst call discussing the firm’s reduced estimate.” *Id.* The Commission determined that “[b]ecause these factors establish materiality,” it did not have to reach the issue of “whether the trading and price decline in Raytheon stock on March 1, 2001 was attributable to Raytheon’s earnings disclosures.” *Id.* The Commission added that such disclosures revealed nonpublic information. *Id.*

160. *See id.* The selective disclosure was made intentionally within the meaning of 243.101(a) of Regulation FD. *Id.* As a result of the violations, Raytheon violated § 13(a) of the Exchange Act and Regulation FD, and the CFO was a cause of Raytheon’s violations of § 13(a) of the Exchange Act and Regulation FD. *Id.*

161. *See id.*

162. *See id.*

163. *See id.*

164. *See id.*

that there was disagreement within the Commission on this issue. Campos' dissent, along with the Commission's careful wording of the order, should alert the marketplace to two important lessons to be taken from the case. First, selective disclosure of earnings guidance to analysts will clearly run afoul of Regulation FD. Second, issuers should be concerned about potentially stiffer sanctions than those sought in *Raytheon* for any such blatant violations in the future.<sup>165</sup>

2. IN THE MATTER OF SECURE COMPUTING CORPORATION  
AND JOHN MCNULTY

In 2002, the SEC instituted and settled administrative cease and desist proceedings against Secure Computing Corporation and its CEO, John McNulty.<sup>166</sup> The SEC alleged that the CEO had disclosed a significant contract to two institutional investors without disclosing that information simultaneously to the public.<sup>167</sup> Specifically, in early 2002, Secure Computing, a software company specializing in Internet security-related products, entered into an important equipment manufacturing agreement with a major buyer.<sup>168</sup> Later, during a March 6, 2002, conference call with a portfolio manager at an investment advisory firm, the CEO, after broadly consulting with Secure Computing's Director of Investor Relations ("IR Director"), disclosed the agreement to the portfolio manager.<sup>169</sup> The IR Director, unaware that the CEO was going to talk about the agreement, realized when the CEO began disclosing the agreement during the conference call that the information had never been publicly announced and that the CEO should not be discussing it.<sup>170</sup> Nevertheless, the IR Director did not interrupt the CEO during the conference call, but instead left the CEO a voicemail later, informing him that he had disclosed nonpublic information.<sup>171</sup> Later that day, but before listening to the IR Director's voicemail, the CEO responded to an

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165. Indeed, the Commission's action in *Schering-Plough* evidences this. See *infra* notes 250-70 and accompanying discussion.

166. *In the Matter of Secure Computing Corporation and John McNulty*, Exchange Act Release No. 46895 (Nov. 25, 2002). In anticipation of the public cease-and desist proceedings, Secure Computing and McNulty each submitted an offer of settlement, which the Commission accepted. *Id.* Without admitting or denying the findings set forth within, Secure Computing and the CEO consented to the entry of the Order Instituting Public Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934. *Id.*

167. See *id.*

168. See *id.* Neither Secure Computing nor the buyer made any public announcement of the agreement. *Id.* The agreement itself required the buyer's consent before Secure Computing could announce the deal. *Id.*

169. See *id.*

170. See *id.*

171. See *id.*

e-mail message from a managing partner of a brokerage firm, and indirectly confirmed that there had indeed been a deal.<sup>172</sup>

The following day, March 7, 2002, after the company received numerous calls from various investors and analysts concerning rumors that were circulating about the agreement, the company's management wanted to issue a press release about the agreement, but the buyer would not agree to it.<sup>173</sup> Nevertheless, the CEO, while conducting conference calls with four additional institutional investors, disclosed during a fourth call with a portfolio manager that Secure Computing had entered into an agreement with the buyer.<sup>174</sup> This disclosure took place at 10:15 a.m. PST.<sup>175</sup> At 1:40 p.m. PST, Secure Computing issued a press release announcing the agreement.<sup>176</sup>

The Commission found that the information the company and CEO had selectively disclosed on March 6 and 7 was material and nonpublic.<sup>177</sup> The Commission also determined that the March 6 selective disclosure was non-intentional, requiring Secure Computing to make prompt public disclosure of the information concerning the agreement, but that the March 7 selective disclosure was intentional, requiring Secure Computing to make simultaneous public disclosure of the agreement.<sup>178</sup> The company's failure to simultaneously publicly disclose the agreement when it made its intentional disclosure to the portfolio manager resulted in the violation.<sup>179</sup> As in the case of *Raytheon*, Commissioner Campos again dissented from the order because of the lack of any civil penalty.<sup>180</sup>

#### SIGNIFICANCE OF CASE

*Secure Computing* is a great case for providing guidance on when prompt versus simultaneous public disclosure is required in matters involving non-intentional versus intentional selective disclosure. Where the company, through its CEO, on March 6 mistakenly selectively dis-

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172. *See id.* "Shortly after sending the e-mail response," the CEO retrieved the IR Director's voicemail message and then called the "managing partner of the brokerage firm and requested that the information be kept confidential." *Id.* Secure Computing made no general public announcement of the agreement on March 6, 2002. *Id.*

173. *See id.*

174. *See id.* The CEO "further explained that the deal had not yet been publicized . . . but that he anticipated an announcement shortly." *Id.*

175. *See id.*

176. *See id.*

177. *See id.*

178. *See id.*

179. *See id.* As a result, Secure Computing violated § 13(a) of the Exchange Act and Regulation FD, and the CEO was a cause of Secure Computing's violations of § 13(a) of the Exchange Act and Regulation FD. *Id.*

180. *See id.*

closed information, the Commission found such selective disclosures to constitute non-intentional disclosures, thus requiring prompt, instead of simultaneous, disclosure. The Commission did not cite the company as violating the prompt public disclosure requirement. In my view, this suggests that the company's public disclosure on March 7 occurred "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" learned of the non-intentional disclosures.<sup>181</sup>

*Secure Computing* is also significant in that it endorses the mechanisms within the regulation that allow some room for mistakes. Where the March 6 selective disclosures were made non-intentionally, as the result of a miscommunication between the CEO and the IR Director, the Commission did not charge the CEO for violations with respect to those selective disclosures. It was not until the March 7 selective disclosure, which took place after the CEO was on notice by the IR Director that his previous disclosures had been selectively disclosed nonpublic information, that the selective disclosure was considered intentional and therefore a violation of the regulation as a result of the lack of simultaneous disclosure to the marketplace. In my opinion, the case did not rest on the March 6 non-intentional disclosures, but rather on the March 7 intentional disclosure. Therefore, the case stands for the proposition that many SEC officials have expressed: that the regulation will not be a trap for the unwary, and that good faith mistakes under the regulation will not be punished.<sup>182</sup>

*Secure Computing* also was significant in that it dealt with the definition of "simultaneous disclosure." While the meaning of the phrase seems obvious, the Commission, through the case, indicated that it would be followed strictly. The company's March 7 public disclosure at 1:40 p.m., approximately three and a half hours after the CEO's intentional selective disclosure at 10:15 a.m., was not sufficient to meet the simultaneous disclosure requirement. Therefore, public disclosure of information made only hours after the intentional selective disclosure will not meet the regulation's simultaneous disclosure requirement. This leads one to conclude that the Commission will strictly enforce the

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181. See Regulation FD, *supra* note 2, at 100(d). The order does not cite the specific times that the March 6 non-intentional disclosure occurred and when the CEO was notified of it. See *Secure Computing*, *supra* note 166. If the March 6 non-intentional selective disclosure had occurred early in the morning, then the March 7 public disclosure probably would have been made too late, as it would have been "after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange." The March 7 public disclosure was not made until after the close of that day's trading. See *id.*

182. See *supra* notes 140-42 and accompanying discussion.

simultaneous disclosure requirement, requiring instantaneous public disclosure once an intentional disclosure has been made. So is there a safety zone in which a public disclosure can be made following an intentional disclosure? What about public disclosures made an hour, thirty minutes, or even five minutes after an intentional disclosure? Or one that is made as fast as it humanly takes to draft a press release following an intentional selective disclosure? Only future cases brought by the Commission will answer that. For now, it has to be assumed that any delay in public disclosure following an intentional selective disclosure will not absolve a company.

Another important issue in the case, as in *Raytheon*, involves Commissioner Campos's dissent. Again, Commissioner Campos dissented because of the lack of a penalty.<sup>183</sup> This signals a belief that companies and their senior officials should be sanctioned severely for violations of the regulation. While Campos appears to be the minority on this issue in the sweep cases, his dissent serves as notice that the Commission may be willing to slap companies with a lot more than just minor cease-and-desist sanctions in future Regulation FD cases.<sup>184</sup>

### 3. IN THE MATTER OF SIEBEL SYSTEMS, INC., AND SEC V. SIEBEL SYSTEMS, INC.

In the sweep case involving the heaviest sanctions, the SEC instituted and settled administrative cease and desist proceedings against Siebel Systems, Inc.,<sup>185</sup> and also filed a civil action against the company in federal district court.<sup>186</sup> In the civil action, Siebel consented, without admitting or denying the Commission's allegations, to pay a two-hun-

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183. *See id.*

184. Another important element of the Commission's order against Secure Computing, one that will receive greater attention in *Siebel*, dealt with the Commission's tendency to look at a company's stock price, and the effect of selective disclosures on the stock price and volume, as having some bearing on the materiality and violative nature of the selective disclosure. *See id.* The Commission noted in the order that Secure Computing's stock had increased eight percent on March 6 on volume that was more than double of that of the day before. *Id.* The Commission also noted that the company's stock price had increased seven percent on March 7 on volume that was 130 percent higher than that of the day before. *Id.*

185. *In the Matter of Siebel Systems, Inc.*, Exchange Act Release No. 46896 (Nov. 25, 2002). In anticipation of public cease-and-desist proceedings, Siebel submitted an offer of settlement, which the Commission accepted. *Id.* Without admitting or denying the findings set forth within, Siebel consented to the entry of the Order Instituting Public Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934. *Id.*

186. *Securities and Exchange Commission v. Siebel Systems, Inc.*, Litigation Release No. 17860 (Nov. 25, 2002); *see also* SEC Files Settled Cease-and-Desist Order Against Siebel Systems, Inc. Finding that it Violated Regulation FD; Siebel Systems, Inc. Also Agrees to Pay a \$250,000 Civil Penalty, SEC Litigation Release No. 17860 (Nov. 25, 2002). The civil action was filed against Siebel in the United States District Court for the District of Columbia. *Id.*

dred-fifty-thousand dollar civil penalty.<sup>187</sup>

*Siebel* involved a violation of the regulation when the CEO of the company selectively disclosed material nonpublic information about the company at an invitation-only technology conference.<sup>188</sup> During the November 2001 conference, hosted by Goldman Sachs & Co., the CEO disclosed material nonpublic information.<sup>189</sup> In response to questions from the Goldman Sachs analyst who organized the conference, the CEO disclosed that his company was optimistic because "its business was returning to normal."<sup>190</sup> These statements by the CEO contrasted with negative statements he had made only three weeks earlier, when he had characterized the market for information technology as "tough," and indicated that his company "expected business to remain that way for the rest of the year."<sup>191</sup> While analyst conferences attended by Siebel's management were normally broadcast to the public, this one was not.<sup>192</sup> Prior to the conference, the company's IR Director knew that the conference would not be simultaneously broadcast to the public, but he failed to tell the CEO.<sup>193</sup> The CEO's disclosures affected the company's stock price and trading volume, with the stock price closing up approximately twenty percent on the day of the conference.<sup>194</sup>

The Commission found that the company had violated the regulation when it failed to simultaneously disclose to the public the material nonpublic information that its CEO had disclosed to those attending the

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187. See *In the Matter of Siebel Systems, Inc.*, Exchange Act Release No. 46896 (Nov. 25, 2002).

188. See *id.* There were 200 attendees at the invitation-only conference, including broker-dealers, investment advisers, investment companies and institutional shareholders of the company's stock. *Id.* Among the attendees was the largest institutional shareholder of Siebel stock. *Id.*

189. *Id.* The format of the conference was an informal question and answer session or "fireside chat" in which the CEO responded to questions from the Goldman Sachs analyst who organized the conference as well as from the audience. *Id.*

190. *Id.*

191. *Id.* On October 17, 2002, the company had reported disappointing third quarter 2001 results, which fell short of analysts' earnings estimates. *Id.* At the time, the CEO said the business environment for information technology had "been tough" and that he thought the environment would "continue to be quite tough in the short term." *Id.*

192. See *id.*

193. See *id.*

194. See *id.* At 10 a.m., when the CEO began speaking at the conference, Siebel's stock was trading at \$18.98 per share. *Id.* The CEO made his relevant remarks in the first ten minutes of his presentation, and by the end of his remarks, Siebel's stock had increased to \$19.81 per share. *Id.* Trading volume during his presentation was high, with more than 4.6 million shares trading hands. *Id.* Following the disclosures, the stock price continued to rise, and by 1 p.m., when reports of the CEO's comments began to surface in the media, the stock went as high as \$20.15 per share (approximately 16.5% higher than the previous day's close). *Id.* Trading volume for the day exceeded 33 million shares, about double the normal trading volume. *Id.* Goldman Sachs was the most active firm trading Siebel stock that day. *Id.*

technology conference.<sup>195</sup> The “company knew going into the conference that it would be attended by persons outside the issuer covered under Regulation FD, including holders of its securities, ‘under circumstances in which it [was] reasonably foreseeable’ that such persons ‘would purchase or sell the [company’s] securities on the basis of the information’ provided at the conference.”<sup>196</sup> The Commission determined the information disclosed by the CEO to be material and nonpublic as it encompassed internal trends in Siebel’s business, and because “a reasonable investor would have considered this information important in making an investment decision regarding the company’s stock.”<sup>197</sup> The Commission found it especially important, in its analysis regarding materiality, that the information “significantly altered the total mix of available information” as the information “sharply contrasted” with statements made by the CEO less than a month earlier.<sup>198</sup> The Commission further looked at the impact of the information disclosed, and noted that immediately following the CEO’s disclosures, conference attendees purchased Siebel stock or communicated the nonpublic information to others who then traded in the stock.<sup>199</sup>

The Commission found the company’s selective disclosure, through the CEO, to be an intentional disclosure, noting that “a disclosure is intentional when the person making the disclosure knows or is reckless in not knowing that the information he is disclosing is both material and nonpublic.”<sup>200</sup> The Commission found that the CEO knew that the information he was disclosing was material and nonpublic at the time he was disclosing it.<sup>201</sup> And even though the CEO did not know that he was disclosing such information selectively, the Commission determined that the company knew or was reckless in not knowing that such information was going to be disclosed selectively, as the IR Director knew that the conference was not going to be public and failed to provide this information to the CEO before the CEO made his statements.<sup>202</sup> Therefore, the Commission attributed the IR Director’s knowledge of the selective disclosure, in conjunction with the CEO’s knowledge that he was disclosing material nonpublic information, in

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195. *See id.* Specifically, the Commission found that the CEO’s disclosures were made to covered persons under the regulation. *Id.*

196. *Id.* (quoting Regulation FD, 17 C.F.R. § 100(b)(1)(iv)). The company knew the conference attendees included broker-dealers, investment advisers, investment companies, and institutional shareholders. *Id.*

197. *Id.*

198. *Id.*

199. *See id.*

200. *Id.*

201. *See id.*

202. *See id.*



finding that the company made an intentional disclosure because it knew or was reckless in not knowing that it was selectively disclosing material nonpublic information.<sup>203</sup>

Along with the administrative action, the Commission also filed a civil action against Siebel in federal court.<sup>204</sup> Siebel consented to a two-hundred-fifty-thousand dollar civil penalty.<sup>205</sup> This action is the only one of the four sweep cases that involved a federal civil court action and a civil monetary penalty.<sup>206</sup> Interestingly, in sharp contrast to Campos's dissent in the other cases, Commissioners Cynthia Glassman and Paul Atkins dissented here to the imposition of a penalty in the civil action.<sup>207</sup>

### SIGNIFICANCE OF CASE

The most significant aspect of *Siebel* compared to the other Regulation FD sweep cases is the fact that a civil action and penalty of two-hundred-fifty-thousand dollar was brought against the company. This is somewhat surprising given that the conduct in *Siebel* does not appear to be as heinous as that in *Raytheon*. *Siebel* did not involve blatant intentional selective disclosures in clear disregard of the regulation. In fact, the CEO was not even charged in this case, as the CFO and CEO, respectively, had been charged in *Raytheon* and *Secure Computing*. Therefore, one has to wonder why Siebel was charged with a two-hundred-fifty-thousand dollar civil penalty, while the other defendant corporations in the sweep cases were not subject to any monetary penalty. There was deep disagreement within the Commission over how to punish those who run afoul of the regulation. Commissioners Glassman and Atkins, in their dissents in *Siebel*, objected to the imposition of a civil penalty against Siebel, while Commissioner Campos objected, in his dissents in *Raytheon* and *Secure Computing*, to the lack of a civil penalty against those companies. The order in *Siebel* does not reveal the reason for the civil penalty; nevertheless, the case is significant in that it is the first to signal that the Commission is willing to seek civil penalties in Regulation FD cases, and that violations of the regulation will not be limited to only administrative cease-and-desist remedies.

*Siebel* also demonstrates how liability can attach to a company as a result of a combination of actions of its senior officials, without liability necessarily being attributed to any one individual senior official. Where

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203. See *id.* As a result, Siebel violated § 13(a) of the Exchange Act and Regulation FD. *Id.*

204. See *Securities and Exchange Commission v. Siebel Systems, Inc.*, Litigation Release No. 17860 (Nov. 25, 2002).

205. See *id.*

206. See *id.*

207. See *id.*

liability in *Raytheon* was against the company through its CFO, and in *Secure Computing* against the company through its CEO, in *Siebel*, the CEO did not independently cause his company to violate the regulation. Instead, it was the actions of several people, most notably the IR Director in conjunction with the CEO, which led to the company's liability.<sup>208</sup> It was the IR Director's actions, in knowingly allowing the CEO to selectively disclose material nonpublic information to covered persons, in conjunction with the CEO's actions in disclosing such material nonpublic information, that led to the violation. Therefore, *Siebel* is significant in that it reveals that the Commission will not necessarily look at the conduct of any one senior official within a company in assessing whether or not a violation has occurred. Rather, the Commission may look at a mosaic of individuals within a company and their intertwining actions and knowledge, when assessing whether a company knew or was reckless in not knowing whether it made a wrongful selective disclosure. This will be the case even when the individual who made the prohibited selective disclosure was not aware that he or she was doing so at the time, because of a miscommunication or otherwise.<sup>209</sup>

Another significant aspect of *Siebel* was the Commission's focus on the reaction of the marketplace to selectively disclosed information as a factor in its analysis of whether there was a violation of the regulation. The Commission looked at the reactions of the conference attendees in purchasing stock immediately after information had been selectively disclosed as evidence that the CEO had communicated new, and thus material, information concerning the company's business.<sup>210</sup> The Commission also explicitly noted the impact of the disclosures on the company's stock price (twenty-percent increase) and trading volume (more than double) as factors evidencing disclosures of material nonpublic information that had been made selectively in violation of the

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208. *See id.*

209. *See id.* The *Siebel* order does not suggest that the CEO realized that he was making a selective disclosure at the time he did so, which, in my view, is the most likely reason he was not charged. *Id.* Yet his actions, in conjunction with the IR Director's knowledge and lack of communication, were attributed to the company. *Id.* Arguably, one has to wonder whether the IR Director should have been charged. The Commission made clear in the order instituting proceedings that the definition of "senior official" in the regulation includes "investor relations or public relations officer." *See id.* at n.8 (citing Rule 101(f)). The IR Director, however, never disclosed the material nonpublic information. *Id.* Therefore, as the IR Director's knowledge could not be attributed to the CEO when the CEO made his disclosure of material nonpublic information, arguably the CEO's disclosure of material nonpublic information could not be attributed to the IR Director, who, while knowing such information would be disclosed selectively, had not made the selective disclosure herself. *Id.* Instead the company was charged. *Id.*

210. *See id.*

regulation.<sup>211</sup> While these factors were not, in and of themselves, key elements in determining whether a violation had occurred, they were considered in the overall decision to bring the action, and they shed some light on the Commission's thought processes in what it considers material and what it looks for in pursuing violations of the regulation.

#### 4. REPORT OF INVESTIGATION OF MOTOROLA, INC.

In a rare move, rather than bringing a federal enforcement proceeding, the SEC issued a 21(a) Report of Investigation against Motorola, Inc. ("21(a) Report").<sup>212</sup> According to the 21(a) Report, the SEC's Division of Enforcement conducted an investigation into whether Motorola Inc. violated the regulation when one of its senior officials "selectively disclosed information about the company's quarterly sales and orders during private telephone calls with sell-side analysts in March 2001."<sup>213</sup> In the phone calls, Motorola's IR Director disclosed to analysts that first quarter sales and orders for the company were down by at least twenty-five percent.<sup>214</sup> This sharply contrasted with an earlier press release and conference call by the company on February 23, 2001, which stated that Motorola's sales and orders were experiencing "significant weakness," that the company was likely to miss earnings estimates of twelve cents per share for the quarter, and that it would "have an operating loss for the quarter if the order pattern continued."<sup>215</sup> After the IR Director had

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211. See *id.*

212. See *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Motorola, Inc.*, Exchange Act Release No. 46898 (Nov. 25, 2002). Section 21(a) of the Exchange Act basically authorizes the SEC to investigate securities law violations and, in its discretion, "publish information concerning any such violations." *Id.* The 21(a) Report did not constitute an adjudication of any fact or issue addressed in it, and Motorola consented to the issuance of the Report without admitting or denying any of the statements or conclusions in it. *Id.* Such 21(a) Reports of Investigation have been issued only three other times in the past seven years. See *Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market* (Aug. 8, 1996); *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co.*, Exchange Act Release No. 39,157 (Sept. 30, 1997); *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, Exchange Act Release No. 44,969 (Oct. 23, 2001).

213. See *Motorola*, *supra* note 212.

214. See *id.*

215. *Id.* During a January 11, 2001, analyst conference call, which had been webcast to the public, Motorola discussed its fourth quarter results, and estimated first quarter 2001 sales at \$8.8 billion and earnings at 12 cents per share. *Id.* On February 23, 2001, Motorola issued a press release stating that "as a result of significant weakness in first quarter" business, the company did not expect to achieve the \$8.8 billion in sales guidance or earnings guidance of 12 cents per share. *Id.* After the press release, the company's President and CEO, in an analyst conference call webcast to the public, again confirmed that the company was "experiencing significant weakness" in its business as compared with its "expectations at the beginning of the quarter." *Id.*

seen analysts' models and concluded that the analysts had not understood from the February 23 conference call just how disappointing the company's quarterly results were going to be, the company decided to telephone the analysts and explain that the word "significant," as used in its February 23 press release and conference call, meant a twenty-five percent "or more" decline.<sup>216</sup>

The Commission found that Motorola selectively disclosed material nonpublic information when the IR Director made the private phone calls to analysts clarifying the company's previous use of the term "significant" and informing them that the company's sales and orders were off by twenty-five percent or more for the first quarter of 2001.<sup>217</sup> The Commission stated that "[w]hen an issuer endeavors to make public disclosure of material information — but later learns that it did not, in fact, fully communicate the intended message, and determines that further disclosure is needed — the proper course of action under Regulation FD is *not* to selectively disclose the corrected message in private communications with industry professionals, but rather to make additional public disclosure."<sup>218</sup> Because, unlike in the other sweep cases, Motorola officials had in good faith sought the advice of in-house legal counsel before engaging in the conduct at issue, and counsel had approved the conduct in question based on an erroneous interpretation that the information was not material or nonpublic, the Commission decided to bring a 21(a) Report rather than an administrative or civil proceeding against the company.<sup>219</sup>

An important aspect of the 21(a) Report in *Motorola* is that the Commission stressed five distinct observations, all intended as guidelines for those seeking to comply with the regulation. The first observation was that the information selectively disclosed by the company was

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216. *Id.* Motorola decided not to issue a press release or make any kind of public disclosure of the additional information. *Id.* After reviewing the analysts' models and concluding that they were overstating the company's likely quarterly results, between March 6 and 12, 2001, the IR Director contacted approximately fifteen analysts to discuss their models and reiterate statements made in the February 23, 2001, press release and conference call. *Id.* In at least ten of these calls, the IR Director informed analysts that when Motorola used the term "significant," it meant a rate of change of twenty-five percent or more. *Id.*

217. *See id.*

218. *Id.* (emphasis by the Commission).

219. *See id.* The IR Director "sought and obtained the advice of Motorola's in-house legal counsel responsible for SEC reporting and disclosure issues." *Id.* Counsel had advised the IR Director that he could contact selected analyst, reiterate information that had been disclosed on February 23, as well as provide quantitative definitions for certain qualitative terms that had been used in the February 23 announcements. *Id.* Counsel based the legal advice on the conclusion that providing a quantitative definition for the term "significant" was not material. *Id.* Counsel also concluded that Motorola's specific definition of the word "significant" was public for regulation purposes. *Id.*

clearly material.<sup>220</sup> The Commission, noting its previous statements that it would not second-guess close calls on materiality, stressed that the information conveyed by the IR Director to analysts was clearly material as there was a substantial likelihood that reasonable investors would consider it important that the company's business was down by twenty-five percent or more for the quarter.<sup>221</sup> The second guideline stressed by the Commission was that senior officials need to be "particularity cautious" during private conversations with analysts.<sup>222</sup> A third observation, which is particular to the facts underlying *Motorola*, is that "after-the-fact private communications of material, nonpublic information to securities professionals" is "not a proper way to supplement a prior public disclosure that the issuer determines to have been misunderstood or misinterpreted."<sup>223</sup> The Commission stated that "[i]f an issuer becomes aware . . . that information it is trying to convey to the public has not in fact been conveyed, and the issuer determines that further disclosure is necessary, the proper course of action under Regulation FD is to make additional public disclosure."<sup>224</sup> A fourth observation by the Commission dealt with the use of "code" words.<sup>225</sup> The Commission said that "[w]hen communicating with securities industry professionals, issuers may not use 'code' words to selectively disclose information that they could not selectively disclose" otherwise.<sup>226</sup> In *Motorola*, the Commission was troubled by the company's use of the term "significant" when the company later engaged in private discussions with analysts and provided "a more detailed quantitative definition of the code word 'significant.'"<sup>227</sup>

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220. *See id.*

221. *See id.* The Commission found this to be the case, even though the company had previously stated that its business was experiencing "significant weakness." *Id.* The IR Director had communicated material nonpublic information by providing a quantitative definition for the term "significant." *Id.*

222. *See id.* The Commission noted that the regulation does not prohibit private discussions with analysts. *Id.* However it stressed that the regulation prohibits the disclosure of material nonpublic information during those discussions. *Id.* Therefore senior officials need to be especially careful about what is discussed and said, during such conversations, as any disclosure of material nonpublic information, intentionally or accidentally, may cause the company to run afoul of the regulation. *Id.*

223. *Id.*

224. *Id.* Therefore, there can be no clarifications of previous public statements when such clarifications are made selectively. *Id.* Yet if such clarifications are made publicly, then there should be no problem. *Id.* In *Motorola's* case, it sought to selectively clarify its use of the term "significant" as conveyed in a previous press release and conference call. *Id.*

225. *See id.*

226. *Id.* As the Commission has stated previously, issuers cannot selectively disclose indirectly what they are prohibited from doing directly. *Id.* The use of "code" words or "winks or nods" as a means of conveying material nonpublic information will be considered the same as a direct explicit disclosure of such material nonpublic information. *Id.*

227. *Id.*

The fifth and most important guidance by the Commission in the 21(a) Report was that, in issuing the 21(a) Report rather than a formal enforcement action, the Commission was “crediting Motorola’s reliance on counsel in the context of this case concerning Regulation FD” because the Commission understood “that legal advice was sought and given in good faith.”<sup>228</sup> The Commission stressed that it encouraged “honest, carefully considered attempts to comply with Regulation FD” and felt that, in Motorola’s case, it appeared that the company had acted “based on advice of counsel, that although erroneous, was sought and given in good faith.”<sup>229</sup> However, while advice of counsel was a mitigating factor concerning the type of remedy sought, the Commission stressed that reliance on counsel would “not necessarily provide a successful defense in all future cases.”<sup>230</sup> It added that “[t]he availability of any reliance on counsel argument” would turn on “all the facts and circumstances” of a case, and in cases “where relevant facts are concealed from counsel” or “where counsel’s advice was not faithfully given and followed,” there would not be “a valid reliance on counsel argument.”<sup>231</sup>

#### SIGNIFICANCE OF CASE

This case is significant because of the reliance on counsel mitigation defense, which allowed the company to receive a 21(a) Report rather than other sanctions. The Commission publicly stated that Motorola had run afoul of the regulation, but that the Commission had determined not to bring an actual enforcement action against the company because of its good faith reliance on counsel. The reliance on counsel argument seemed to be a strong one within the Commission, as this case was the only one of the four sweep cases that did not involve any dissension among the commissioners.<sup>232</sup> So should one glean *Motorola* to

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228. *Id.*

229. *Id.*

230. *Id.*

231. *Id.* The Commission stated that in situations where “in some cases counsel’s advice may provide the officer with a good faith basis for making the disclosure at the time the advice is received, but the officer later learns of additional information that puts him or her on notice that the information being disclosed is material and nonpublic,” then such disclosure will constitute a clear violation of the regulation, notwithstanding counsel’s prior advice. *Id.* For example, after making a selective disclosure that he or she believes in good faith is not material, an officer may become aware of a very significant market reaction and may learn facts indicating that this reaction was a result of the selective disclosure. *Id.* At that point, even though the officer’s original selective disclosure was not intentional, the issuer has learned that it has made a non-intentional selective disclosure and must make the prompt selective disclosure required under Regulation FD. *Id.*; see also Regulation FD 17 C.F.R. §§ 243.100(a)(2), 101(d). Moreover, if the issuer makes any additional selective disclosures of the information thereafter, these disclosures would be deemed intentional under the regulation. See *Motorola*, *supra* note 212.

232. See *id.* Whereas in the sweep cases, Commissioner Campos was seeking more severe

allow a valid reliance on counsel defense as a basis for allowing companies to escape any real sanction in future cases? Definitely not. In the 21(a) Report, the Commission specifically cautioned that where an "officer knows that the information to be selectively disclosed would be important to the reasonable investor, he or she cannot seek out and rely on counsel's consent as a shield against liability."<sup>233</sup> The Commission stated that a company's CFO or IR Director may have a "keener awareness than company counsel of the significance of information to investors," and therefore cautioned that "[c]onsultation with counsel will not relieve the officer from responsibility for disclosure of information that he or she personally knows, or is reckless in not knowing, is material and nonpublic."<sup>234</sup> Even more important, the Commission cautioned at the end of the 21(a) Report that "having now issued this Report," it "would be less likely in the future to credit reliance on counsel" as a mitigating factor in future actions.<sup>235</sup> This was a key warning by the Commission that the *Motorola* case did not create a *per se* reliance on counsel defense. Instead, the case seemed to signify the Commission's desire to encourage issuers to seek advice of counsel on issues concerning compliance with the regulation, while also cautioning issuers that they will not necessarily be able to hide behind the shield of any such advice in the future when they are in a better position than counsel to know whether material nonpublic disclosures have been made.

Other significant aspects of the case deal with the guidelines given by the Commission regarding the definition of materiality, "after-the-fact" selective clarifications of prior public disclosures, and the prohibited use of "code" words. Also noteworthy in *Motorola*, as was seen in the other cases, was its consideration of the impact on the company's stock price as a result of the selective disclosures.<sup>236</sup>

### VIII. SCHERING-PLOUGH

Following the Regulation FD sweep in November 2002 came another changing of the guard at the SEC, with the appointment of a new Chairman, William H. Donaldson, a person on the record as criticizing

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sanctions, and Commissioners Glassman and Atkins were seeking less severe sanctions, in *Motorola* the commissioners all concurred with the outcome of a 21(a) Report. *Id.*

233. *Id.*

234. *Id.*

235. *Id.*

236. *See id.* The Commission stated that "[b]etween March 6 and March 12 — the period of the phone calls at issue — the price of Motorola stock declined from \$17.70 to \$15.00, a drop of more than 15%." *Id.* "There were also significant increases in trading volume of Motorola stock at most of the firms where analysts were contacted." *Id.*

the regulation. But as Donaldson's actions would later reveal, he was not necessarily an opponent of the regulation.

A. *The Donaldson Factor: Skeptic or Supporter?*

In November 2002, amid a politicized and stormy tenure at the SEC, Harvey Pitt announced his resignation, and the following month President Bush named William H. Donaldson to chair the agency.<sup>237</sup> Donaldson, co-founder of the investment bank Donaldson, Lufkin & Jenrette and former head of the New York Stock Exchange, was someone deemed by many who could bring a wealth of experience to the SEC.<sup>238</sup> Yet, as the political forces in Washington evaluated and scrutinized Bush's choice to head the SEC, a position vital in restoring badly needed investor confidence during a time of scandal, Donaldson's previous negative statements about the regulation began to surface.

One of the first criticisms leveled against Donaldson, after his nomination but before his confirmation, concerned his previous criticisms of Regulation FD.<sup>239</sup> In an interview approximately a year before his nomination, Donaldson had been quoted as calling Regulation FD a "terrible rule."<sup>240</sup> Referring to the chilling effect associated with the regulation, he opined that the rule was "crazy in terms of what it does to the free flow of information."<sup>241</sup> He said the regulation was "paralyzing communications between analysts and companies."<sup>242</sup>

The media reported on Donaldson's past statements, and some considered him an opponent of the regulation.<sup>243</sup> His potential views thus became a topic of concern for investors, as they began to wonder what Donaldson's chairmanship would mean for the regulation.<sup>244</sup> Some went so far as to look at Donaldson's previous statements on the regulation and question whether he was reform-minded and sufficiently quali-

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237. See Kathleen Day, *President Names Insider to Lead SEC; Donaldson Headed N.Y. Stock Exchange*, WASH. POST, Dec. 11, 2002, at A1.

238. *Id.*

239. *Id.*

240. See Justin Schack, *The Pioneers*, INST. INVESTOR, Oct. 1, 2001, at 104.

241. *Id.*

242. *Id.*

243. See Day, *supra* note 237, at A1; Daniel Dunaief, *SEC Nominee Under Fire*, N.Y. DAILY NEWS, Dec. 12, 2002, at 67; Greg Farrell, *Bush Picks Polar Opposite of Pitt to Take Over at SEC; Donaldson Seen as Warm and Smooth*, USA TODAY, Dec. 11, 2002, at B1; Neal Lipschutz, *Point of View: Disclosure for New SEC Head More Than FD*, DOW JONES NEWS SERVICE, Dec. 12, 2002.

244. Rob Wells, *SEC Nominee Donaldson: Fair Disclosure Rule 'Terrible,'* DOW JONES INT'L NEWS, Dec. 11, 2002. Yet some questioned Donaldson's ability to change the regulation even if he wanted to, in light of the reform movement to clean up Wall Street in the wake of Enron and other corporate scandals. See Tony Cooke, *Swimming Against the Tide Is Tough*, DOW JONES CORPORATE FILINGS ALERT, Dec. 16, 2002; Dunaief, *supra* note 243, at 67.



fied to lead the agency during the scandalous times in the marketplace.<sup>245</sup>

Against this backdrop, Donaldson went before the Senate Banking Committee on February 5, 2003, for his confirmation hearing, where he faced, among other things, questions concerning his views on the regulation.<sup>246</sup> During the hearing, Donaldson expressed his support for the regulation, and stated that he would not propose changing it.<sup>247</sup> Saying his prior statements had been "taken out of context," he added that he was "totally for the intention of the law" and felt that the regulation was "working better" since the time he had made his comments.<sup>248</sup> He nevertheless vowed as chairman to "constantly monitor the implementation" of the regulation and make sure that it was not having unintended consequences.<sup>249</sup>

### B. Schering-Plough

A month later, in March 2003, Schering-Plough Corporation announced that the SEC's staff planned to recommend action against the company and its CEO under Regulation FD.<sup>250</sup> While Donaldson proclaimed himself a supporter of the regulation, everyone knew that actions would speak louder than words, and the Schering-Plough matter was closely watched to see whether the previous skeptic of the regulation would indeed become a supporter.<sup>251</sup>

On September 9, 2003, the Commission brought and filed two settled enforcement proceedings: an administrative proceeding against Schering-Plough and its former CEO, and a civil proceeding against the company, hitting the corporation with a one million dollar civil penalty, and the CEO with a fifty-thousand dollar civil penalty, the first of its

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245. See Justin Schack, *Thus Spake Bill Donaldson*, INST. INVESTOR, Jan. 1, 2003; *Wall Street in Washington*, N.Y. TIMES, Dec. 13, 2002, at A38.

246. See Stephen Labaton, *S.E.C. Choice Says He's No Harvey Pitt*, N.Y. TIMES, Feb. 6, 2003, at C1.

247. See *id.*

248. See Neal Lipschutz, *Point of View: Donaldson Is Now Okay with Regulation FD*, DOW JONES NEWS SERVICE, Feb. 6, 2003. Saying his previous quotes concerning the regulation had been "taken out of context," Donaldson stated that "his initial reaction was I thought it was crazy, because, at that time, I was chairman of a major U.S. corporation that was trying to deal with the implementation of it, and I was in the throes, at that time, thinking there were some unintended consequences." *Id.* Stating that he was in favor of the law, he nevertheless said that "at that time there were some unintended consequences that were having just the reverse effect, shutting down information flow." *Id.*

249. *Id.*

250. See Kathleen Day, *Schering-Plough, CEO May Face SEC Charges*, WASH. POST, Mar. 13, 2003, at E2. It was reported that on March 11, 2003, the SEC gave the company a Wells notice informing the company that the SEC staff planned to recommend that the Commission bring a civil action against the company and its chief executive officer. *Id.*

251. See *id.*

kind against an individual for violations of Regulation FD.<sup>252</sup> Specifically, the Commission brought a federal civil action in the United States District Court for the District of Columbia charging Schering-Plough with violating Regulation FD and section 13(a) of the Exchange Act and seeking a monetary penalty of one million dollars.<sup>253</sup> The Commission simultaneously issued an administrative order likewise finding that Schering-Plough had violated the regulation and section 13(a), and additionally finding that the company's former chairman and CEO, Richard J. Kogan, was a cause of Schering-Plough's violations.<sup>254</sup>

In the proceedings, the Commission charged that during the week of September 30, 2002, the CEO and Schering-Plough's vice president for investor relations met privately in Boston with analysts and portfolio managers of four institutional investors, three of which were among Schering's largest investors.<sup>255</sup> At the meetings, "through a combination of spoken language, tone, emphasis, and demeanor," the CEO disclosed negative material nonpublic information concerning the company's earnings prospects, including information revealing that the analysts' earnings estimates for the company's 2002 third-quarter were too high and that the company's 2003 earnings would significantly decline.<sup>256</sup>

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252. *Schering-Plough Corp.*, Exchange Act Release No. 48,461, Admin. Proceeding File No. 3-11,249 (Sept. 9, 2003); SEC Files Settled Regulation FD Charged Against Schering-Plough Corp. and its Former Chief Executive, Litigation Release No. 18,330, Case No. 1:03CV01880 (D.D.C.) (CKK) (Sept. 9, 2003).

253. *Id.* Without admitting or denying the Commission's allegations and findings, Schering-Plough consented to the entry of a final judgment requiring it to pay a one million dollar civil penalty. *Id.*

254. *Schering-Plough Corp.*, Exchange Act Release No. 48,461, Admin. Proceeding File No. 3-11,249 (Sept. 9, 2003). Without admitting or denying the Commission's allegations and findings, Kogan agreed to a fifty-thousand dollar civil penalty in the administrative proceedings, and both Schering-Plough and Kogan agreed to entry of the Commission's cease-and-desist order. *Id.*

255. *See id.* The four institutional investors were Wellington Management Company ("Wellington"), Massachusetts Financial Services Company ("MFS"), Fidelity Management & Research Company ("Fidelity"), and Putnam Investments ("Putnam"). *Id.* Wellington, Fidelity, and Putnam were Schering-Plough's largest investors. *Id.*

256. *See id.* On September 30, 2002, the CEO and Schering-Plough's investor relations officer had a dinner meeting with Wellington's pharmaceutical analyst and several of Wellington's portfolio managers, during which the CEO informed them that Schering-Plough was going to take a "hard hit" to 2003 earnings, that he did not favor having the company repurchase its own shares, that the company's manufacturing costs would increase in 2003, and that no significant costs cuts were planned. *Id.* The following day, the CEO and the investor relations officer met with the pharmaceutical analyst and several portfolio managers at MFS, and the CEO informed them that 2003 was going to be a "very, very difficult" year for the company, and that "the street" had not significantly lowered earnings estimates for the third quarter of the third quarter of the company's 2002 fiscal year. *Id.* The CEO also stated that he did not favor the company repurchasing its own shares. *Id.* Following the meeting, the CEO and investor relations officer then met with the pharmaceutical analyst and several portfolio managers for Fidelity. *Id.* At this meeting, the CEO stated that 2003 would be a "tough" or "difficult" year for the company's earnings, that the

Immediately after the meetings, analysts at two of the firms downgraded their ratings on the company, and portfolio managers at three of the firms dumped their Schering-Plough stock.<sup>257</sup> Following the downgrades and selloff, the company's stock price plunged by more than seventeen percent during the course of a three day period, from \$21.32 to \$17.64 per share, on almost four times normal volume.<sup>258</sup> On October 3, 2002, while Schering-Plough stock was still actively being sold off, the CEO held a previously scheduled private meeting with approximately twenty-five analysts and portfolio managers at Schering-Plough's headquarters, during which he informed them, among other things, that his company's 2003 earnings would be "terrible."<sup>259</sup> Later that evening, the company issued a press release that provided earnings guidance for 2002 and 2003 materially below analysts' consensus estimates and, with respect to the 2002 fiscal year, materially below the company's own prior earnings guidance for that year.<sup>260</sup>

The Commission found that Schering-Plough violated Regulation FD, and that the CEO caused the violations, when the company provided earnings guidance containing material nonpublic information in private meetings with institutional investors and analysts, and failed to publicly disclose such information as required by the regulation.<sup>261</sup> The Commission found that, even though the CEO's purpose may not have been to "suggest that institutional investors sell" Schering-Plough stock, "his

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company would not be significantly cutting costs in 2003, and that the company's gross margins would be negatively impacted by the sale of more royalty-based products and increased manufacturing expenses. *Id.* Following the meeting with Fidelity, the CEO and investor relations officer then met with the pharmaceutical analyst and numerous portfolio managers at Putnam. *Id.* At this meeting, the CEO provided material nonpublic information concerning revenues of one of its products, and indicated that Wall Street consensus earnings estimates for the third quarter of the company's 2002 fiscal year were too high. *Id.* All of these statements made to Wellington, MFS, Fidelity, and Putnam were materially different from the company's prior public disclosures, and thus resulted in selective disclosures in violation of Regulation FD. *Id.*

257. *See id.* Fidelity and Putnam downgraded their ratings on Schering-Plough. *Id.* The portfolio managers at Fidelity, Putnam, and Wellington heavily sold off their holdings of Schering-Plough stock. *Id.* Fidelity and Putnam each sold more than ten-million shares over a three-day period after the meetings, their sell-off accounting for more than thirty percent of the overall market during that period. *Id.*

258. *Id.* The volume topped twenty million shares traded per day compared with the company's average volume of less than five million shares traded per day. *Id.*

259. *Id.* The October 3 meeting was neither webcast nor accessible to the public. *Id.* In the session, the CEO told the analysts that "next year will be tough, real tough," and that the company's earnings would be "terrible." *Id.* The CEO also said the company's gross margins would deteriorate because of royalty expenses and manufacturing spending. *Id.*

260. *See id.* The company issued the press release after it received numerous press inquiries concerning whether the CEO had actually used the word "terrible" in describing 2003 earnings. *Id.*

261. *See id.*

conduct failed to meet the requirements” of the regulation.<sup>262</sup> The CEO’s “statements, demeanor and general expressions of concern” for his company’s “prospects” during private meetings amounted to selective disclosure and prompted a significant selloff in the company stock.<sup>263</sup>

The Commission stated that the one-million dollar penalty against Schering-Plough was the largest penalty ever obtained for a violation of the regulation, and that the penalty against the CEO was the first civil penalty ever obtained against an individual for violation of the regulation.<sup>264</sup> Reflecting similar dissent to the imposition of a civil penalty in *Siebel*, Commissioner Atkins dissented to the imposition of a penalty against Schering-Plough in the civil action.<sup>265</sup>

#### SIGNIFICANCE OF CASE

The most significant aspect of the case is that it was a sign from the Commission that the regulation was here to stay. The Commission slammed Schering-Plough and its CEO with heavy penalties after the Commission had, through the sweep cases, put the market on notice that it would indeed enforce the regulation, Chairman Donaldson did not appear to pull any punches in his first chance to enforce the regulation. Instead of backing off or mitigating any civil penalties sought, as Commissioner Atkins in his dissent appears to have wanted, Chairman Donaldson and the Commission as a whole came down hard in the first real case brought in a new Regulation FD enforcement world.

The civil penalties sought in *Schering-Plough* are also very significant. The one-million dollar penalty obtained against the company is four times that of the only civil penalty in the sweep cases, the two-hundred-fifty-thousand dollar penalty in *Siebel*. This signals a new trend that companies will be hit and hit hard when they run afoul of the rule, and it is conceivable that seven- or eight-figure civil penalties may well rule the day in future cases when companies cross the line in violation of the regulation.

Another significant aspect of the case involves the fifty-thousand dollar civil penalty against the CEO, the first ever against an individual

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262. *Id.*

263. *See id.* The Commission stated that “[t]hese communications are precisely the kind of selective disclosures that Regulation FD was designed to prevent.” *Id.*

264. *See SEC Files Regulation FD Charges Against Schering-Plough Corporation and Its Former Chief Executive*, SEC Release 2003-109 (Sept. 9, 2003). In bringing the case, SEC Enforcement Director Stephen M. Cutler warned that “[b]estowing an information advantage on a select few at the expense of others undermines investors confidence and cannot be tolerated.” *Id.*

265. *See Schering-Plough Corp.*, Exchange Act Release No. 48,461, Admin. Proceeding File No. 3-11,249 (Sept. 9, 2003).

for violations of the regulation. This reveals for the first time that the Commission is willing to impose a civil penalty on individuals for causing their companies to violate the regulation. Not only was the civil penalty the first for an individual, it is also, in my opinion, most likely the beginning of an enforcement trend in which the SEC will hold individuals monetarily accountable for violations of the regulation as a result of their actions. And like the first corporate civil penalty in *Siebel* for two-hundred-fifty-thousand dollars, which jumped fourfold to one-million dollars in *Schering-Plough*, it is quite conceivable that the fifty-thousand dollar civil penalty against the CEO in *Schering-Plough* will be a low baseline figure and that future civil penalties against senior officials who cause their companies to run afoul of the regulation will be much higher.

It is also significant that the Commission looked at the CEO's "statements, demeanor and general expressions of concern" for his company's earnings prospects in determining that he had disclosed material nonpublic information.<sup>266</sup> The case did not involve a straightforward confirmation or denial of earnings estimates, rather the Commission looked at "a combination of spoken language, tone, emphasis, and demeanor" in finding that the CEO disclosed material nonpublic information concerning the company's earnings prospects.<sup>267</sup> In its legal analysis, the Commission went so far as to cite *Motorola* to confirm the rule that "[i]ssuers may not evade the public disclosure requirements of Regulation FD by using 'code' words or 'winks and nods' to convey material nonpublic information during private conversations."<sup>268</sup> *Schering-Plough* thus fortifies the notion that all forms of communication used in disseminating selective information to investors may cause senior officials to cross the line and cause the company to violate the regulation.

It also illustrates that senior officials need to be very careful when speaking with covered persons under the regulation, for almost anything they say, not already in the public domain, can land them in big trouble, especially when it relates to concerns or factors relevant to earnings information. The Commission in *Schering-Plough*, while acknowledging that the company and CEO "were free to convey the serious concerns they had over Schering's earnings prospects to industry professionals," warned that the company could not selectively do so as it "had a legal obligation to disseminate that information to the rest of the

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266. *Id.*

267. *Id.*

268. *Id.*

marketplace in accordance with Regulation FD.”<sup>269</sup> Therefore, corporate officers need to be mindful that their statements may unintentionally create a selective disclosure situation when taken in conjunction with certain mannerisms and other statements made when disseminating information bordering on selective disclosure.<sup>270</sup>

*Schering-Plough* signaled that future enforcement of the regulation will be stricter, with less tolerance for questionable deviations, and likely to involve heavier penalties. The weight of the sanctions in *Schering-Plough*, coming on the heels of the initial sweep cases, should serve as a warning to corporations and their officers that they must be more prudent in complying with the regulation because they can and will get hit with an enforcement action if they violate the regulation.

## IX. FUTURE SURVIVAL AND ENFORCEMENT OF REGULATION FD

Several lessons can be learned from the story of the regulation’s fight for survival and the subsequent enforcement actions under it. The regulation will survive and become a core regulation in the federal securities laws. And future enforcement actions will involve stricter interpretations of the regulation, as well as stiffer sanctions, now that the corporate community has been put on notice by the Commission.

### A. *Regulation FD Will Survive Relatively Unchanged and Become an Essential Rule in the Federal Securities Laws*

The regulation will survive and become an essential part of the securities laws. *Schering-Plough* confirmed that, with its seven-figure sanction and its novel action against an individual. If the regulation was going to have been substantially modified or repealed, it would have happened during its earlier days, when there was hardcore resistance to it. The regulation has survived an initial attack by a very influential opponent, the very securities industry that had benefited from the old system of selective disclosure. The regulation also has survived a severe bear market for which some had held it partially responsible. Weather-

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269. *Id.*

270. *See id.* In *Schering-Plough*, the Commission looked carefully at how the meetings with the CEO and his statements were interpreted. *Id.* Besides looking at the statements’ obvious market effect on price, the Commission cited several reports by the covered persons who had heard the statements and cited their interpretations of the information they had heard. *Id.* For example the Commission cited one Fidelity analyst, who downgraded the stock following his meeting with the CEO, as stating in a report within his company that the meeting “made me think that 2003 guidance will be worse than expected and could come on the Q3 earnings call in October.” *Id.* The Commission had also cited a Putnam analyst, who likewise downgraded the stock following his meeting with the CEO, as noting that “[w]hile [the CEO] was not explicit, the very interesting meeting left us with the impression that numbers for consensus certainly had been too high for the quarter and for 2003.” *Id.*

ing all that, the rule has become embedded as a fundamental regulation within the federal securities laws, and it is therefore doubtful that the regulation will be repealed or modified in the foreseeable future.

While there are still those who wish for a bright-line definition of materiality under the rule, it is very difficult to provide such a definition without significantly limiting the scope of the regulation. The Commission has resisted providing bright-line definitions of materiality in the past, because many of the situations in which materiality is an issue are extremely fact- and circumstance-based. Providing a bright-line rule could exclude certain kinds of conduct that the regulation was designed to prevent. For the regulation to adapt to the future, when the market structure and financial products offered may be very different than what they are today, it will need to be broad enough to prevent selective disclosures, regardless of shape or form, when such disclosures involve the dissemination of material nonpublic information. The regulation as currently drafted should be left alone so that it will be able to stand the test of time, much as the Securities Act of 1933 and Exchange Act of 1934 have done since the days of the Great Depression.

### B. *Future Enforcement Actions*

The Regulation FD sweep cases were a shot across the bow regarding the Commission's enforcement of the regulation. The sanctions were relatively mild, and the cases were more notable for providing enforcement guidelines under the regulation than for punishing companies for violating it. Nevertheless, *Schering-Plough* signaled a more stringent position by the Commission in dealing with violations of the regulation.

#### 1. STIFFER SANCTIONS IN THE FUTURE

As evidenced by *Schering-Plough*, the Commission has shown that it is willing to seek stiffer sanctions for violations of the regulation. Once the Commission brought its first series of cases, and effectively put the marketplace on notice that it planned to enforce the rule, it confirmed in *Schering-Plough* that it would slap companies with larger sanctions for violations in the future. Likewise, *Schering-Plough* was the first case in which the Commission obtained civil monetary penalties against an individual who caused a company's violation, thus putting the corporate governance world on notice as to the Commission's enforcement position relating to individuals. Now that corporate officers are on notice, civil monetary penalties against such individuals may become larger in future cases. It is doubtful that there will be future cases such as *Secure Computing*, where the Commission faulted the company and

its CEO for intentionally making a selective disclosure and then merely slapped the company and CEO with administrative cease and desist orders.<sup>271</sup> Instead, as *Schering-Plough* illustrates, companies and senior officials who violate of the regulation will do so at their own financial cost.<sup>272</sup>

2. MISTAKES BY COMPANIES AND THEIR SENIOR OFFICIALS ARE LESS LIKELY TO BE TOLERATED

Seeking to calm the marketplace's initial apprehension about the regulation, Commission officials stressed time and time again that it would not be seeking enforcement actions against companies and officers who attempted to comply with the regulation in good faith.<sup>273</sup> In the period immediately after the rule's enactment, the Commission wanted to thaw any potential chilling of issuer communications as a result of the regulation and to ease corporate fears about compliance with the rule. However, now that the regulation has become embedded in the federal securities laws and corporations have had time to figure out and adjust to the regulation's requirements, it will be harder for companies and their senior officials to avoid the consequences of violations.

In the sweep cases, most of the companies and their senior officials received relatively light sanctions — and in *Motorola*, no real sanction at all — more or less because of mistaken interpretations of the regulation or a lack of internal communication. However, it is doubtful that such mistakes and or unintended violations will be treated as lightly in the future. And *Siebel*, the only sweep case involving a monetary penalty, illustrates the Commission's willingness to bring an action against a company where a violation may have resulted from a lack of communication within an organization.<sup>274</sup>

3. RELIANCE ON COUNSEL DEFENSE LESS LIKELY IN THE FUTURE

Counsel, both in-house and external, will need to be sharp on the regulation in order to protect issuers from violating it. *Motorola* illus-

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271. See *Secure Computing*, *supra* note 166. The Commission in *Secure Computing* made clear that it would not tolerate ignorance on the part of senior officials when they are told that their selective disclosures involve the dissemination of material nonpublic information. *Id.*

272. See *Schering-Plough Corp.*, Exchange Act Release No. 48,461, Admin. Proceeding File No. 3-11,249 (Sept. 9, 2003); SEC Files Settled Regulation FD Charged Against Schering-Plough Corp. and its Former Chief Executive, Litigation Release No. 18,330, Case No. 1:03CV01880 (D.D.C.) (CKK) (Sept. 9, 2003).

273. See *supra* notes 139-47 and accompanying discussion.

274. See *In the Matter of Siebel Systems, Inc.*, Exchange Act Release No. 46896 (Nov. 25, 2002).



trated that good faith reliance on counsel could be a mitigating factor.<sup>275</sup> The case also emphasized, however, that a reliance on counsel argument will be less tolerated in the future. Noting that it encouraged "honest, carefully considered attempts" at compliance with the regulation, the Commission warned that "reliance on counsel will not necessarily provide a successful defense in future cases."<sup>276</sup> The Commission stressed that the "availability of any reliance on counsel" defense would turn on "all the facts and circumstances" of a case.<sup>277</sup> It then stated that "[c]learly, in cases where relevant facts are concealed from counsel, or where counsel's advice was not faithfully given and followed, there will not be a valid reliance on counsel argument."<sup>278</sup> In particular, in cases where corporate officers know that information to be selectively disclosed would be important to reasonable investors, then such information would be deemed material, and corporate officers will not be able to "seek out and rely" on counsel's advice or consent as a "shield against liability" under the regulation.<sup>279</sup> The Commission also determined that, given that senior officials in many cases may have a better awareness of the significance of information to be disclosed than counsel, consultation with counsel under such circumstances will not relieve the company and its senior officials "from responsibility for disclosure of information" that they personally know, or are reckless in not knowing, is material and nonpublic.<sup>280</sup>

These comments by the Commission suggest that a company's senior officials often may be better judges of what is or is not material than counsel. In such cases, senior officials will not be able to pass off materiality questions to counsel and then later make a valid reliance on counsel argument. It is my opinion, however, that if senior officials have obtained competent counsel and have provided counsel with all of the relevant information necessary for counsel to render a fully informed materiality judgment call, then the senior officials, irrespective of the extensiveness of their knowledge, may still be able to assert a valid reliance on counsel defense.

#### X. RECOMMENDED CORPORATE CONDUCT IN LIGHT OF RECENT ENFORCEMENT ACTIONS

While an enumeration of the policies and procedures that corpora-

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275. See *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Motorola, Inc.*, Exchange Act Release No. 46898 (Nov. 25, 2002).

276. *Id.*

277. *Id.*

278. *Id.*

279. *Id.*

280. *Id.*

tions should implement in seeking compliance with the regulation is beyond the scope of this Article, two basic procedures should, in my view, receive special attention in light of recent enforcement actions by the SEC. First, companies need to have corporate counsel intensively involved in materiality judgment calls in order to protect themselves. Second, companies need to have strong procedural systems in place in order to prevent violations of the regulation.

*A. Counsel Needs to be Intensively Involved in  
Materiality Judgment Calls*

For a company to protect itself, it will need to retain competent counsel and provide such counsel with all information necessary to properly render legal advice. Fully informed legal advice on the materiality of selective disclosures will do two things. First, it will allow the company to comply with the regulation and stay clear of any issues that could warrant enforcement action. Second, in my opinion, such legal advice may, in specific circumstances, provide the company with a good faith reliance on counsel defense.

1. COMPANIES NEED TO ENSURE THEY RECEIVE COMPETENT  
ADVICE FROM COUNSEL

For a company to protect itself from liability under the regulation, or to be able to invoke a reliance on counsel defense in seeking to mitigate liability for violations of the regulation, the company needs to retain competent counsel and give such counsel all information necessary to render competent advice. Then, and only then, might a company be deemed to have relied in good faith on counsel's advice. Two steps are involved. First, the company will need to obtain competent counsel, either in-house or outside, who is knowledgeable about the regulation and about materiality in general. Second, the company will need to provide counsel with all relevant information to allow such counsel to make a fully informed judgment on the materiality of any relevant disclosures.<sup>281</sup> This may, in my opinion, allow the company to rely on counsel's expertise in the law of the regulation, rather than on counsel's knowledge of the facts, which, if limited, would not support a reliance on counsel defense. This is especially true for external counsel, who may not be as knowledgeable about the company as in-house counsel.

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281. The Commission has cautioned that "if consultation with counsel merely results in counsel reciting the legal standard for materiality and asking the chief financial officer's or investor relation officer's opinion whether a reasonable investor would consider the information significant, then the resulting judgment is really the company officer's, not counsel's." *Id.*

## 2. IN-HOUSE VERSUS EXTERNAL COUNSEL

The position of counsel rendering advice can be an important factor in materiality judgment calls. In-house counsel is usually in a better position than external counsel to make materiality judgment calls, as in-house counsel is more intimately involved with the company and its senior officials and thus will have a sharper knowledge of the disclosures at issue. However, as *Motorola* illustrates, in-house counsel can still make the wrong calls.<sup>282</sup> Therefore, companies, in order to protect themselves and accrue the full benefit of their in-house legal staff, need to continuously train in-house counsel on the regulation. Likewise, in-house counsel will need to ensure that they are intricately involved in all situations in which selective disclosures will be made, which will give in-house counsel the knowledge base necessary to render the appropriate materiality judgment call. In tough calls concerning materiality, in-house counsel may want to use external counsel as a second source or backup for its own decisions regarding materiality. This use of external counsel will serve as further protection for the company, and provide further evidence of adequate reliance on counsel, should a problem arise.

The use of external counsel, instead of internal counsel, can also protect the company from liability under the regulation. Again, assuming competent counsel is retained, it is important to make sure external counsel is fully informed of all facts and circumstances underlying a selective disclosure. The Commission has warned that senior officials will not be able to rely on counsel for materiality questions when the senior officials have a "keener awareness" than counsel of the significance of disclosed information to investors.<sup>283</sup> As it will be difficult to substitute external counsel's knowledge for that of a CEO or CFO in assessing the significance of certain kinds of information, external counsel particularly will need to be informed of all relevant facts and circumstances underlying a selective disclosure in order to render the kind of legal advice that will allow the company to make a reliance on counsel defense in the future.

Regardless of whether in-house or external counsel is used in rendering a materiality judgment call, it is important that the company adhere to counsel's advice. If there is a pattern of intermittent disregard of counsel's advice on selective disclosure issues, the company would not arguably be relying on counsel's advice, and instead could be deemed to have been making materiality judgment calls on its own. Likewise, if counsel is only broadly informed of selective disclosure

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282. *Id.*

283. *Id.*

issues or serves only to rubberstamp selective disclosures the company considers important, then counsel will not have been properly rendering advice on the selective disclosure issues.

B. *Companies Need Strong Procedural Systems to Prevent Violations of the Regulation*

In the future, it will be more difficult for companies to attribute violations of the regulation to error on the part of their senior officials. The Commission made important statements in *Raytheon*, *Secure Computing*, and *Schering-Plough* when it charged the companies for violations resulting from the actions of their senior officials. And the Commission made an even more blunt statement when it brought an action exclusively against the company in *Siebel* for actions by the company's employees that, when combined, created a violation of the regulation and attributed liability to the company. In light of the fact that the Commission has not shown any reluctance to bring actions against corporations based on the conduct of their senior officials or, in the case of *Siebel*, based on the concerted conduct by their senior officials, companies need to be careful to avoid violations of the regulation by *all* of their employees. This is especially true in light of the fact that the Commission has stressed in *Motorola* that reliance on counsel will "not necessarily provide a successful defense" in "future cases."<sup>284</sup> Therefore, companies need to ensure that they have systems in place that will prevent all kinds of selective disclosures prohibited by the regulation.

While the specific policies and procedures issuers should implement will need to be thorough and tailored to the corporation's management structure, it is safe to say in light of the recent enforcement cases that such policies and procedures should address at least a few basic components. First, the policies and procedures should be designed to prevent any kind of selective disclosure by any one senior official, or concerted actions by multiple senior officials. This might be accomplished by instituting safeguards that require the screening of all proposed communications by senior officials to covered persons before the communications are made. This would serve to not only ensure that material nonpublic information will not be intentionally disclosed, but will also serve to inform, as well as remind, senior officials of their obligations under the regulation when entering into selective communications. In matters involving conference calls to multiple covered persons, such as analysts, the screening should also involve a confirmation as to whether the conference call will or will not be simultaneously

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284. *Id.*

broadcast to the public. If it will be broadcast to the public, then safeguards should be established to ensure that public notice has been made of the conference call, via a press release, before the senior official speaks. Likewise, if it turns out that the conference call will not be broadcast to the public, then the senior official should be made aware of that fact beforehand so a *Siebel* situation does not develop, where the senior official mistakenly believed that his remarks were being disseminated publicly. Another safeguard would be to have legal counsel present during all selective disclosures made to covered persons, regardless of whether the disclosures were designed to be disseminated to the public or private, or whether the information to be provided could be considered material or non-material. This would serve again as a reminder to the senior official of his or her obligations under the regulation and would give counsel the opportunity to immediately intervene if a non-intentional selective disclosure is made.

## XI. CONCLUSION

The story of Regulation FD's survival in the face of powerful opposition, and against the backdrop of a grueling bear market, is the tale of how one of the greatest securities rules of modern times ultimately prevailed. Just as it took the Crash and the Great Depression to lead to the calls for market regulation that resulted in the Securities Act of 1933 and Exchange Act of 1934, it took the recent corporate scandals involving Enron and others to beat back the securities industry's fierce resistance to Regulation FD.

Now that Regulation FD is a permanent fixture in the securities laws, with no real threat of being modified or repealed, recent enforcement actions have provided the corporate community with a better understanding of what conduct is prohibited under the regulation. The recent actions also have granted issuers the knowledge base necessary to fine-tune their corporate disclosure practices. Issuers should now be in a better position to confidently comply with the regulation, without fear of SEC enforcement repercussions. With a corporate atmosphere more adjusted to the compliance obligations under Regulation FD, the practice of selective disclosure, as it existed prior to 2000, will hopefully end once and for all.