The Securities and Exchange Commission's Regulation Fair Disclosure: Parity of Information or Parody of Information?

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COMMENTS

The Securities and Exchange Commission’s Regulation Fair Disclosure: Parity of Information or Parody of Information?

I. INTRODUCTION

January 29, 2001 - Morgan Stanley, one of the biggest investment banks advising corporate America, gave a restricted briefing to securities analysts about managerial changes at the very top. An article in The Economist later criticized these restrictions, which extended to journalists and even to shareholders. Morgan Stanley defended the restrictions, stating that nothing released in the meeting was “material.” The reporter, however, questioned why an elite group of overworked analysts would bother to attend a meeting if Morgan Stanley would not release any material information, and why Morgan Stanley restricted access if the information was not material. Incidents of selective disclosure, “haven’t escaped our attention” said Stephen Cutler, Deputy Head of Enforcement for the Securities and Exchange Commission (SEC), and the disgruntled Economist reporter feels confident that the SEC will launch an investigation into Morgan Stanley’s restricted briefing.

Briefings like the one described above are not new to Wall Street; they have been common practice for many years. So why should the reporter expect an investigation? Morgan Stanley’s briefing occurred just a few months after the SEC’s outgoing chairman, Arthur Levitt spoke these lofty words:

Like that neighborhood with gated entrances and tall fences, moving

2. Id.
3. Id. Information is material if “there is a substantial likelihood that a reasonable shareholder would consider it important” in making an investment decision. TSC Indus. Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). 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.
4. Economist, supra note 1, at 73.
5. Id.
into the information loop is not always an option for many of America's small investors, Regulation FD would bring all investors, regardless of the size of their holdings, into the information loop — where they belong. To all of America's investors, it's well past time to say, "Welcome to the neighborhood."\(^7\)

On August 10, 2000, the SEC voted three to one to adopt Regulation FD and stop selective disclosure.\(^8\) Regulation FD created a firestorm of over 6,000 comment letters during its proposal phase.\(^9\) The disclosure rule drew sharp criticism from the securities industry, praise from consumer groups and individual investors, and nearly divided the SEC.\(^10\)

This comment evaluates the regulation through the prevailing theory of efficient capital markets to argue that Regulation FD is unnecessary and, although passed to enhance the flow of market information to all investors, it will decrease market efficiency, increase issuer compliance costs, and provide for a more volatile market that erodes investor confidence. Part II discusses the SEC's battles against selective disclosure and insider trading that led to the passage of Regulation FD. It identifies the key changes from the proposal to the final rule, explains the new regulation, and defines key terms in Regulation FD. Part III considers the workings of the securities market as articulated in the Efficient Capital Markets Hypothesis and reflects on the need for a specific rule governing selective disclosure. Part IV addresses the potential pitfalls and traps the new regulation holds for issuers, even after the changes from the proposal, and discusses the many ways Regulation FD may provide for increased private securities litigation. Part V suggests the possible ramifications of Regulation FD may have on the market. This comment then concludes with a brief analysis as to why efficient market operation should prevail in the efficiency versus fairness debate and explains how the SEC may have created a cure that will harm investors more than the disease it aims to eradicate.

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\(^7\) Id.


\(^10\) Supra note 8.
II. PRELUDE TO REGULATION FD

A. The SEC's Crusade Against Insider Trading and Selective Disclosure

Selective disclosure occurs when an issuer discloses material information to a select audience, typically a small group of analysts or institutional investors, before making broad public disclosure by a press release or a SEC filing. Unlike classic insider trading, where the insider trades based on material nonpublic information in a breach of his fiduciary duty to the shareholders of the corporation, selective disclosure was not specifically prohibited by the federal securities laws. The distinction lies in the fact that tippees (those who receive inside information) may not have a fiduciary duty to the corporation’s shareholders. Historically, courts have not interpreted the securities laws to impose liability on those who receive or trade on inside information (tippees) absent a breach of fiduciary duty. The cases that follow show how the SEC has attempted to stamp out selective disclosure and insider trading. The cases illustrate the precedents that led Chairman Levitt and the SEC to propose and later adopt Regulation FD.

In Chiarella, the Supreme Court reversed the conviction of a financial printer who handled announcements of takeover attempts and traded before public announcement. The Court held that a duty to disclose under §10(b) of the Securities Exchange Act of 1934 did not arise from mere possession of nonpublic market information. Chiarella was not an agent or fiduciary of the sellers. Therefore, he had no duty to disclose the information to the sellers before trading.

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The argument has been made, both explicitly and by implication, that the function of the antifraud rule is to place all exchange transactors on a parity of information with all others — to deny informational advantages to any person dealing in the securities market over any other person with whom he deals. Whether or not such an egalitarian utopia could be achieved, there is good reason to question whether it should, or whether the antifraud provisions are intended to (or do) go that far. Certainly they do not explicitly go that far. And nothing in the legislative history suggest so sweeping a purpose.

Id. (footnote omitted).


15. Id. at 236-37.

16. Id. at 235.

17. Id. at 232-33. In Chiarella, the Supreme Court reversed judgment on the fiduciary duty
Later in *Dirks v. SEC*, the SEC attempted to extend insider-trading liability to an analyst who received information from an insider that an insurance company had vastly overstated its assets. The analyst investigated the allegations through other company employees and even tried to have the story published in the *Wall Street Journal*. While investigating the company, however, the analyst discussed the information with his clients and investors, who sold their holdings in the company as a result. The SEC argued that the insider not only passed the inside information along to Dirks, but also passed to Dirks a fiduciary duty to the corporation's shareholders not to disclose the information. The Supreme Court rejected the SEC's claim that Dirks inherited any such duty and reaffirmed that, "[a] duty [to disclose] arises from the relationship between parties and not merely one's ability to acquire information because of his position in the market." Further, the Court reiterated its position in *Chiarella* that "formulation of an absolute equal information rule should not be undertaken absent some explicit evidence of congressional intent."

The Court did say, however, that tippees must assume an insider's duty to the shareholders if the information has been made available to them improperly. Thus, the Court determined the insider breaches his fiduciary duty if the insider personally benefits, either directly or indirectly, from his disclosure. The insider in *Dirks* did not receive a benefit, and absent a breach by the insider, Dirks could not commit a derivative breach.

Shortly after the *Dirks* decision, SEC Commissioner Edward Fleischman said, "[t]he fact is that the SEC does not accept *Dirks.*" Commissioner Fleischman then referred to a popular quotation in *SEC v. Bausch & Lomb* stating the company-to-analyst interaction is a "fencing match conducted on a tightrope" and added the warning that the

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19. Id. at 649-50.
20. Id. at 650.
21. Id. at 656.
22. Id. at 657-58.
23. Id. at 658 n.16.
24. Id. at 660.
25. Id. at 662.
26. Id.
28. 556 F.2d 8 (2d Cir. 1977).
29. Id. at 9.
SEC is "trying hard to electrify the tightrope."\textsuperscript{30} The SEC asserted this position against Phillip J. Stevens through a very narrow interpretation of the personal benefit test articulated in \textit{Dirks}.\textsuperscript{31}

Mr. Stevens was the former CEO and Chairman of Ultrasystems Corporation.\textsuperscript{32} Ultrasystems missed earnings estimates by a considerable margin one quarter, and an analyst publicly questioned Mr. Stevens's ability to properly forecast his company's earnings.\textsuperscript{33} The SEC alleged that in the following quarter Mr. Stevens selectively disclosed information to analysts in an attempt to improve his professional reputation with analysts, which satisfied the personal benefit test of \textit{Dirks}.

Stevens, without admitting or denying the allegations, entered into a consent decree. As a result, the SEC's theory that reputation can be used to establish a personal benefit under \textit{Dirks} did not undergo judicial scrutiny.\textsuperscript{35}

The \textit{Dirks} decision, in the eyes of many scholars, did not support the SEC's narrow position even though it referred to "reputational benefit" as part of the objective criteria considered in the personal benefit test.\textsuperscript{36} Specifically, Professor John Coffee points to the sentence in \textit{Dirks} immediately following reference to a "reputational benefit that will translate into future earnings," where the Court quotes Professor Victor Brudney: "The theory . . . is that the insider, by giving the information out selectively, is in effect selling the information to its recipients for cash, reciprocal information, or other things of value for himself."\textsuperscript{37} Because Mr. Stevens entered into a consent decree, the facts in his case were not fully developed, but Professor Coffee lists several factors that indicate Mr. Stevens could have successfully defended his actions under the \textit{Dirks} precedent.\textsuperscript{38} The SEC in its attempt to prosecute Mr. Stevens, however, made its point to issuers and securities industry professionals that it would give \textit{Dirks} the narrowest possible reading.

Thus, the legality of selective disclosure and its relationship with insider trading rested on a consent decree and an uncertain interpretation of personal benefit. In the absence of a specific duty to disclose, the

\textsuperscript{30} Coffee, \textit{supra} note 27, at 5.


\textsuperscript{32} \textit{Id.} at *1.

\textsuperscript{33} \textit{Id.} at *2.

\textsuperscript{34} \textit{Id.}

\textsuperscript{35} \textit{Id.} at *1.

\textsuperscript{36} Coffee, \textit{supra} note 27, at 5.


\textsuperscript{38} Coffee, \textit{supra} note 27, at 5.
federal securities laws do not require an issuer to publicly disclose all material events as soon as they occur. Although some self-regulatory organizations (SROs) require prompt disclosure of material information, issuers retain some control over the timing, the audience, and the forum of many important corporate disclosures. According to Chairman Levitt, "[t]his practice leads to potential conflicts of interest for analysts and undermines investor confidence in our markets." Regulation FD seeks to eliminate selective disclosure.

B. Revision or Division: Rule and Definition Compromises

The SEC proposed Regulation FD on December 20, 1999 and provided a comment period during which the SEC received nearly 6,000 comment letters. Over 5,000 of the comments came from individual investors voicing support for the proposed regulation. Comments from industry professionals and law firms, while joining in the SEC's concern about fairness, expressed serious concerns about the practical effects of the proposed regulation.

In the proposing release, the SEC cited a recent academic study that analyzed trading during conference calls. The study sampled 1,056 corporate conference calls made by 808 firms from February to November 1995 to determine whether conference calls provide information to investors and whether other investors have equal access to the information provided during conference calls. The authors relied on observations that stock price volatility and trading volume increased during conference calls to conclude that information must be provided during such calls. Additionally, the authors concluded that conference calls do not provide equal access to all investors because the average trade size increased during conference calls, meaning institutional investors
use the information to trade in real time.\textsuperscript{48}

Although the SEC cites this study as supporting the need for Regulation FD, the conclusions in the study actually undermine the need for such a regulation. Two organizations have reported that individual investor access to conference calls has increased significantly since the 1995 date of the study.\textsuperscript{49} According to a survey by the National Investor Relations Institute (NIRI) released in August 2000, sixty-one percent of 2,492 companies surveyed already webcast their corporate conference calls for access by the media and individual investors and another twenty-two percent planned to webcast their conference calls within the next year.\textsuperscript{50}

Thus, prior to Regulation FD, individual investors were increasingly privy to conference call information and could also make a quick profit or minimize losses by trading in real time.\textsuperscript{51} With the trend in conference calls moving toward open access prior to Regulation FD, the benefit of a rule requiring such access seems minimal while the cost of ensuring strict compliance and exposure to additional legal liability seems onerous. Thus, it may be more likely that under Regulation FD the information discussed in conference calls will be watered-down or scripted due to the fear of additional liability exposure. Ultimately, Regulation FD may reduce the usefulness and effectiveness of what was an increasingly open and valuable medium of disclosure.

The SEC also referenced several news reports claiming analysts now rely less on independent research and more on access to corporate insiders.\textsuperscript{52} The SEC expressed a conflict of interest concern that is twofold: (1) issuers feel compelled to give access and information to analysts in order to receive favorable ratings; and (2) analysts feel compelled to give issuers favorable ratings to ensure continued access and receive future business for their firms with the company (i.e. subsequent offerings).\textsuperscript{53} While Regulation FD will reduce the pressure companies

\textsuperscript{48} Id.


\textsuperscript{50} Press Release, National Investor Relations Institute, NIRI Surveys Finds Adoption of Regulation Full Disclosure Likely to Limit Amount of Information Disclosed to Market Participants: Survey also finds 61% Now Webcast Conference Calls; Another 22% Planning To Do So Within the Next Year (Aug. 2000), at http://www.niri.org/publications/alerts/EA080800.cfm.

\textsuperscript{51} Id. The authors of the study concluded that issuers released information during conference calls and that those privy to the conference calls could trade on and profit from in real time. The problem cited was limited access. Since issuers have increasingly opened up access to individual investors, it follows that individual investors may also profit from conference calls.

\textsuperscript{52} Proposing Release Comments, supra note 11, at II, 72,592-93 n.18.

\textsuperscript{53} Id. at 72,592-93.
feel regarding access for analysts, there is no reason to believe that analysts will no longer feel pressure to give issuers favorable ratings in order to receive future business for their firms.

Ostensibly, the SEC created parity by enacting Regulation FD. Rule 100 of Regulation FD sets forth the basic rule regarding selective disclosure. Broken down into its major elements, this rule requires that whenever: (1) an issuer, or person acting on its behalf; (2) discloses material nonpublic information; (3) to certain enumerated persons (in general, securities market professionals or holders of the issuer’s securities who may well trade on the basis of the information); (4) the issuer must make public disclosure of that same information: (a) simultaneously (for intentional disclosures); or (b) promptly (for non-intentional disclosures).  

Regulation FD places the “responsibility for avoiding selective disclosure and the risks of engaging in it, on the issuer and persons acting on behalf of the issuer.” The SEC limited the definition of “person acting on behalf of an issuer” in Regulation FD’s final form to mean: (1) any senior official of the issuer; or (2) any other officer, employee, or agent of an issuer who regularly communicates with certain enumerated persons.

The SEC did not change the “materiality” standard from the proposed rule. The standard is based on existing case law. Information is material if “there is a substantial likelihood that a reasonable shareholder would consider it important” in making an investment decision. To fulfill the materiality requirement, there must be a substantial likelihood that the fact “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”

During the proposal stage of Regulation FD, the least controversial definition of personnel covered was the “any person” definition, referring to anyone receiving the material, nonpublic information. The regulation enumerates four categories, three of which are securities market professionals, and the final category provides a catch-all for any holder of the issuer’s securities who may reasonably trade based on the infor-

58. Id.
While these individuals are not the primary targets of Regulation FD, some levels of conduct may give rise to aiding and abetting liability for violating the regulation.60

"Nonpublic" refers to information that has not been "disseminated in a manner making it available to investors generally."61 The final version of Regulation FD allows more flexibility satisfying the "public disclosure" element. According to the proposal, an issuer could file a Form 8-K to satisfy the public disclosure requirement, distribute a press release through a widely disseminated news or wire service, or use any other non-exclusionary method of disclosure.62 The final version allows issuers to file or furnish a Form 8-K, or disseminate "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."63 Ironically, although the SEC cites the emergence of the internet as a reason for the passage of Regulation FD, disclosure over a corporation's website does not constitute public disclosure.64

The SEC recognizes that many disclosure situations require snap judgment by issuer personnel and made a key concession to concerned commentators.65 In its final form, Regulation FD applies a recklessness standard to determine whether a disclosure was intentional.66 According to Rule 101(a), a person acts "intentionally" only if the person knows or is reckless in not knowing that the information he or she is communicating is both material and nonpublic.67

In the event of non-intentional disclosure, public disclosure must be "prompt." The final version that states the outer boundary of prompt disclosure as the later of twenty-four hours or the commencement of the next day's trading on the New York Stock Exchange, after a senior official learns of the disclosure and knows (or is reckless in not knowing) that the information disclosed was material and nonpublic.68

Perhaps the most important revision in the eyes of industry professionals is the exclusion of Regulation FD from the anti-fraud provisions of the Securities Exchange Act. No private cause of action arises from a violation of Regulation FD.69 Since its goal is to promote more public

59. Official Comments, supra note 56, at 57,719.
60. Walker, supra note 55; see Official Comments, supra note 56, at II(B)(7).
61. Official Comments, supra note 56, at II(B)(2) 51,721.
62. Proposing Release Comments, supra note 11, at II(B)(5), 72,596.
64. Proposing Release Comments, supra note 11, at II(A), 72,593, II(B)(5)(b), 72,597.
65. Id. at II(B)(2), 72,594.
67. Id. (emphasis added).
disclosure, a violation does not affect Exchange Act reporting status either.\textsuperscript{70}

These changes to Regulation FD reflected more than the mere concerns voiced by industry professionals in the comment period. This Regulation almost divided the SEC. In a speech before the American Society of Corporate Secretaries, Commissioner Isaac Hunt expressed his reservations that Regulation FD as proposed, "would be extremely costly to corporations and provide little benefit to investors."\textsuperscript{71} Without some of the changes explained above, Commissioner Hunt may have sided with Commissioner Unger and rejected Regulation FD.

III. THE SEC OVERSTATED THE NEED FOR REGULATION FD

A. The Efficient Capital Markets Hypothesis (ECMH)

The changes implemented in the adopted version of Regulation FD reduced the cost to issuers, but did not provide any further benefit to investors compared to the proposal. Thus, Commissioner Hunt’s assertion that the proposed rule would provide little benefit to investors also applies to the final rule.\textsuperscript{72} His skepticism concerning the beneficial effect of the regulation on investors may reveal an appreciation for Efficient Capital Market Hypothesis (ECMH).

The ECMH asserts that the price of a security reflects all relevant information available in the market about that security and changes instantaneously with any release of new, relevant market information.\textsuperscript{73} The semi-strong form of the ECMH posits that current market prices reflect all publicly available information.\textsuperscript{74} More specifically: one cannot profitably trade on the basis of public information. The Supreme Court adopted this form of the ECMH as the most appropriate model for the existing market.\textsuperscript{75}

The ECMH does, however, have some flaws. Even though the speed of today’s markets provides for a very rapid adjustment to reflect all publicly available information, the change is not instantaneous. Therefore, absent selective disclosure, the ability to profit from new

\begin{itemize}
  \item \textsuperscript{70} 17 C.F.R. §243.103 (2001).
  \item \textsuperscript{72} Id.
  \item \textsuperscript{73} Paul P. Brountas Jr., Note, Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts, 92 COLUM. L. REV. 1517, 1534 (1992).
  \item \textsuperscript{74} Id. The ECMH assumes that stocks are heavily traded and its assertions do not apply to thinly-traded stocks. Thus, the lack of trading activity in some stocks may provide lag time between the release of information and the reflection of such information in the stock price.
  \item \textsuperscript{75} See Basic Inc. v. Levinson, 485 U.S. 224 (1988).
\end{itemize}
information still exists. The window of opportunity, however, is shortened. Not surprisingly, industry professionals are better poised to act immediately upon receipt of new information than individual investors. This ability to react quicker minimizes the possible benefit to individual investors derived from the elimination of selective disclosure.

B. **The Conflicts of Interest Raised by the SEC May Satisfy the Dirks Personal Benefit Test**

Recall that the SEC has a two-fold conflict of interest concern: (1) issuers feel compelled to give access and information to analysts in order to receive favorable ratings; and (2) analysts feel compelled to give favorable ratings to issuers in order to ensure continued access and receive future business for their firms with the company (i.e. subsequent offerings).\(^7\) If the SEC discovered such conduct, the test articulated in *Dirks* provides the necessary vehicle.\(^7\) The *Dirks* Court explained objective facts and circumstances that suggest *quid pro quo* would satisfy the personal benefit test.\(^7\) An issuer who revealed material non-public information to an analyst in return for a “buy” rating, in effect sold the information. This is the scenario the SEC intimates when justifying the need for Regulation FD. That scenario, however, is clearly covered under the *Dirks* “personal benefit.”\(^7\) Therefore, Regulation FD does not solve any problems arising from the *Dirks* decision and imposes unnecessary burdens upon issuers.

C. **Regulation FD Casts Too Wide A Net**\(^8\)

An issuer may be wary of dealing with a recently-investigated analyst. Also, an issuer that just had a disclosure investigated may be unwilling to talk to analysts for fear of another investigation, even if the prior investigation did not result in a violation. Although the regulation is intended to bolster investors’ confidence in the markets, the SEC may actually undermine issuer confidence in analysts, analyst confidence in issuers, and ultimately investor confidence in both.

In the words of Commissioner Unger, who voted against the regulation, “Regulation FD turns on its head the longstanding relationship between issuers and their analysts - a liaison that has never been particularly easy.”\(^8\) She even referred to the Second Circuit’s comparison of

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78. *Id.* at 663-64 n.15.
79. *Id.*
81. *Id.*
the corporate official/analyst exchange as a “fencing match conducted on a tightrope,” by asking if the SEC has finally cut the tightrope.\textsuperscript{82} The considerable uncertainty between what constitutes immaterial information that completes a mosaic and what information is material creates a pitfall for issuers and analysts alike.

IV. \textbf{POSSIBLE TRAPS AND PITFALLS IN THE FINAL RULE}

\textbf{A. The SEC’s Calming Campaign}

Some readers may wonder why Regulation FD caused such alarm on Wall Street and drove law firms to send out numerous client letters warning them of the dangers of the regulation.\textsuperscript{83} Securities professionals and law firms saw so many traps and pitfalls for issuers that the SEC began a calming campaign to ease their fears. The SEC issued several interpretive guidelines and sent commissioners and staff around the nation to speak to nervous securities professionals.

Perhaps the most insightful speech of this campaign came from Richard Walker, the SEC’s Director of Enforcement.\textsuperscript{84} Walker spoke to the Compliance and Legal Division of the Securities Industry Association (SIA), giving the Enforcement Division’s perspective on Regulation FD.\textsuperscript{85} He began with an imaginary conversation between an analyst and brokerage firm’s compliance officer. In the “conversation,” the compliance officer was too afraid to give the analyst his first name without first having his lawyers advise him whether such disclosure would violate Regulation FD.\textsuperscript{86} “Regulation FD was \textit{not} designed as a trap for the unwary, as many law firms are counseling. In fact, the Commission took a number of steps in revising the final rule for the specific purpose of disarming many potential traps.”\textsuperscript{87} Walker explained that Regulation FD is not a fraud rule and creates no private liability. He further explained that the standard for a violation is recklessness, and issuers are not responsible for selective disclosures made by mid-level management and junior employees.\textsuperscript{88} He added that aggressive enforcement of Regulation FD would “frustrate the purpose of the rule – which is to promote broader and fairer disclosure of information to investors – by second-guessing reasonable disclosure decisions made in good faith, even if we don’t agree with them.”\textsuperscript{89}

\textsuperscript{82} \textit{Id.} (referring to SEC v. Bausch & Lomb, 556 F.2d 8, 9 (2d Cir. 1977)).

\textsuperscript{83} Walker, \textit{supra} note 55.

\textsuperscript{84} \textit{Id.}

\textsuperscript{85} \textit{Id.}

\textsuperscript{86} \textit{Id.}

\textsuperscript{87} \textit{Id.} (emphasis added).

\textsuperscript{88} \textit{Id.}

\textsuperscript{89} \textit{Id.}
After attempting to allay the Securities Industry Association’s fears, Walker then reminded his audience “the Enforcement Division is not a toothless tiger.” 90 He warned the SIA’s Compliance and Legal Division that the Enforcement Division will be on the lookout for two types of violations. 91 Egregious violations involving intentional or reckless disclosure of information that is unquestionably material will certainly warrant enforcement action. 92 Such violations include selectively disclosing mergers, earnings, or other matters that courts have long held to be material. 93 Attempts to defraud the system will also be pursued. 94 These violations include a pattern of purportedly non-intentional disclosures that steps over the line or providing indirect guidance to select audiences through winks, nods, or other coded responses. 95 Enforcing these types of violations seems reasonable and aimed at protecting individual investors. Issuers can hardly claim to be caught by traps or pitfalls when conduct rises to this level.

Walker’s speech also touched some controversial aspects of Regulation FD that left an air of uncertainty. For example, Regulation FD clearly prohibits the common practice of “walking the Street” up or down. 96 “Walking the Street” is when issuers inform analysts that an earnings forecast is too low or too high under current conditions. 97 What is not so clear is when issuers may confirm prior guidance. 98

Walker referred to a recent release by the SEC’s Division of Corporation Finance addressing this topic and several other Regulation FD concerns. 99 Regulation FD does not necessarily prohibit confirmation, but it does make confirmation relatively pointless. If an analyst calls an issuer the day after disclosure, confirmation would usually be permitted. If an analyst calls mid-quarter, however, confirmation may violate Regulation FD. 100 The Division of Corporation Finance explains that if confirmation would be “material,” then the confirmation would violate Regulation FD. 101

Materiality regarding confirmation would typically depend on

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90. Id.
91. Id.
92. Id.
93. Id.
94. Id.
95. Id.
96. Id.
97. See id.
99. See id. Walker, supra note 55.
100. Supra note 98, at No. 1.
101. Id.
intervening events, the amount of time that has elapsed since public disclosure, and where the issuer is in the earnings cycle.\textsuperscript{102} It is easy to envision many close scenarios, but according to Walker, those scenarios would not be investigated due to the recklessness standard and the SEC's desire not to thwart the purpose of its own regulation by overzealous enforcement.\textsuperscript{103}

B. Material versus Mosaic

Walker moves onto thin ice, however, as he discusses what is referred to as "mosaic information."\textsuperscript{104} In the adopting release, the SEC specifically stated:

\begin{quote}
[A]n issuer cannot render material information immaterial simply by breaking it into ostensibly non-material pieces. At the same time, an issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a "mosaic" of information that, taken together, is material. Similarly, since materiality is an objective test keyed to the reasonable investor, Regulation FD will not be implicated where an issuer discloses immaterial information whose significance is discerned by the analyst. Analysts can provide a valuable service in sifting through and extracting information that would not be significant to the ordinary investor to reach material conclusions. We do not intend, by Regulation FD, to discourage this sort of activity. The focus of Regulation FD is on whether the issuer discloses material nonpublic information, not on whether an analyst, through some combination of persistence, knowledge, and insight, regards as material information whose significance is not apparent to the reasonable investor.\textsuperscript{105}
\end{quote}

In the Regulation FD context, a violation depends on the issuer's knowledge that the information he provides will complete the mosaic. If the issuer knowingly provides information that completes an analyst's mosaic, that information would then fall under the caution that completion of the mosaic must be "unbeknownst to the issuer."\textsuperscript{106} Alternatively, the SEC could assert that the issuer actually attempted to render material information immaterial by breaking it into seemingly non-material pieces.\textsuperscript{107}

Despite all the analyst's legitimate labor and research providing the majority of the picture, the issuer could run afoul of Regulation FD if

\begin{itemize}
\item \textsuperscript{102} Id.
\item \textsuperscript{103} Walker, supra note 55.
\item \textsuperscript{104} Id.
\item \textsuperscript{105} Official Comments, supra note 56, at II(B)(2), 51,721 (emphasis added).
\item \textsuperscript{106} Id.
\item \textsuperscript{107} Id.
\end{itemize}
one of the issuer’s FD-covered personnel knowingly provides the last immaterial piece of the puzzle. The requirement that a company must *unknowingly* provide the immaterial information completing a mosaic is not supported by case law. As a result, attempts to pursue this approach may encounter courts hostile to the alteration. In application and enforcement, the SEC may not pursue such a situation, but the possibility of facing an enforcement action due to an analyst’s diligent research and the issuer’s attempt to attract a new investor may be enough to significantly hinder the efforts of both parties.

Walker unintentionally provides an example in his speech. He referenced the popular Janus Mutual Fund commercial where Janus boasts that its analysts investigated a fire prevention system used by a computer company in which Janus considered investing. A traditional sprinkler system would put out a fire but damage the computers in the process. Janus analysts discovered this company employed a dry fire prevention system that would not damage the computers. According to Walker, Regulation FD will reward this kind of diligence. “That commercial is about mosaic information, pure and simple.” The specific language of the adopting release, however, does not draw such a clear line.

Both the Janus commercial and Walker’s reference to it lead investors to believe the analysts found out about this fire-prevention system *unknowing*st to the issuer. What if the issuer, in an attempt to show management forethought and attract Janus as an investor, specifically pointed this fire-prevention system out to the analysts during a tour of the facilities? Janus and Walker portray that information about the system as essential to the overall determination by the analysts - the final piece of the mosaic. When information completes the mosaic and the issuer knows that providing such specific information to the analyst would influence an investment decision, would it not also be important information for a reasonable investor to make an investment decision? If so, it is an intentionally selective disclosure of material, nonpublic information. Walker’s own example of model diligence and mosaic information would violate Regulation FD.

108. A skilled analyst with knowledge of the company and the industry may piece seemingly inconsequential data together with public information into a mosaic which reveals material nonpublic information. Whenever managers and analysts meet elsewhere than in public, there is a risk that the analyst will emerge with knowledge of material information which is not publicly available. Elkind v. Liggett & Myers, Inc. 635 F.2d 156, 165 (2d Cir. 1980). The *Elkind* case first articulated the mosaic theory. Based on the quotation above, the mosaic theory does not require the analyst receive the inconsequential data *unknowing*st to the issuer.


110. *Id.*

111. *Id.*

Applying the example's facts to Regulation FD's analysis would look-like this: (1) the computer company; (2) revealed a unique fire-prevention system (material because issuer knowingly provided information that completed the mosaic) during a tour of the facility; (3) to the analysts; (4) intentionally without making simultaneous public disclosure. Thus, if the issuer pointed out the fire-prevention system to the analysts knowing it would complete the mosaic, the issuer violated Regulation FD. Conversely, if the issuer intentionally provided the same information without knowing it completed the mosaic, the information would not be deemed material. Since the information would not be material, the issuer would not violate Regulation FD.

The SEC, however, may not believe a reasonable investor would have even considered whether the company had a fire suppression system before making an investment decision. If so, the information would not be material. It could be considered under the theory that material information was broken into seemingly immaterial pieces. "[S]ince materiality is keyed to the reasonable investor, Regulation FD will not be implicated where an issuer discloses immaterial information whose significance is discerned by the analyst." Notice that the preceding statement by Walker in discussing Janus's commercial, does not reference whether the issuer knowingly provided this information to the analysts. Under the limited facts in Walker's version of the Janus example, the issuer would most likely not be in violation of Regulation FD. Given the additional facts in the modified hypothetical, however, the issuer's intent in pointing out the fire protection system is designed to influence the analyst's decision. Would there be a violation? Is the information still immaterial because the analysts are more sophisticated than an ordinary investor? If you ask an investor whether he would want to know this information, the investor will almost certainly say such information would be important in his decision.

C. The Hindsight Problem

This example points out the problem of hindsight in Regulation FD investigations. If the computer company in the Janus example experiences considerable stock price gains within a short period of time, information that might have been viewed as immaterial may in hindsight be viewed as material (and nonpublic since not every investor gets to tour the facility). The hindsight problem stems both from the standpoint of the reasonable/ordinary investor standard used for materiality purposes and in the recklessness standard applied to the issuer's conduct.

113. Id.
Given the reports cited in the SEC’s proposing release of Regulation FD, the SEC appears to believe that analysts and corporate officials are too cozy and analysts rely more on access to corporate insiders than on genuine analysis. If the SEC has adopted this skeptical view of the efforts of analysts, why then would the SEC even believe that the Janus analysts actually based their decision on diligent research? Did not the company really just tell them some secret information and the analysts claimed the fire prevention system helped complete their “mosaic?”

Obviously, earnings estimates and fire-prevention systems are different types of information. Regardless, material information is material information and a rise in stock price may attract the attention of the Enforcement Division, especially when closely correlated in time to a major market participant, like Janus, investing in the company. Basically, this ambiguity allows for significant after-the-fact speculation about what really happened when the issuer met the analyst.

The SEC is a respected agency and has a track record of exercising restraint, but it should be remembered that “the Enforcement Division is not a toothless tiger.” The recklessness standard should prevent the institution of penalties in such a situation, but it gives the Enforcement Division a vehicle to go on a “fishing expedition” and Regulation FD may provide plaintiff lawyers with a roadmap for private enforcement efforts. Although the SEC stated that a Regulation FD violation is not deemed a violation of the antifraud provisions, courts ultimately determine the scope of 10b-5 liability and may hold otherwise.

V. POTENTIAL EFFECTS AND COST/BENEFIT ANALYSIS

The SEC must have seen a compelling need for Regulation FD for the SEC to pass a regulation that casts such a wide net and that may have considerable impact on market confidence. The SEC only references a few academic studies and news reports, however, in the proposing release. During the comment period, many securities industry

114. Proposing Release Comments, supra note 11, at 72,591.
115. If this type of second-guessing seems unlikely, refer back to the Economist article discussing Morgan Stanley’s restricted meeting contained in the introduction. Farewell, Fair disclosure?, ECONOMIST, Feb. 10, 2001, at 73.
118. “[T]his deference is constrained by our obligation to honor the clear meaning of a statute, as revealed by its language, purpose, and history. On a number of occasions in recent years this Court has found it necessary to reject the SEC’s interpretation of various provisions of the Securities Acts.” IBT v. Daniel, 439 U.S. 551, 566 n.20 (1979) (discussing court deference to SEC interpretations).
119. See Proposing Release Comments, supra note 11.
professionals argued that the SEC had not demonstrated a need for this regulation.120 The SEC did not hold any hearings or embark on any fact-finding expeditions.121 The SEC did not even suggest a Blue Ribbon panel to determine best practices.122

Despite the lack of procedural safeguards and evidence demonstrating a need for Regulation FD, Chairman Levitt said selective disclosure is an “all-too-common” and “insidious” practice.123 In fact, the National Investor Relations Institute provides a different picture of the need for this regulation.124 NIRI’s August 2000 survey demonstrates that public companies have already started using the internet to provide greater access to the individual investor.125 In spite of this evidence, calls from securities professionals for alternative measures, the possibility of negative effects on the market, and an overall lack of evidence presented in support of the need for Regulation FD, the SEC adopted the regulation on August 10, 2000.126

Many questions linger regarding material versus mosaic, hindsight judgments, intentional versus nonintentional, and many other areas of Regulation FD. The question that remains is how will those lingering questions affect issuers, analysts, and investors? If issuers can no longer “walk the Street” up or down regarding earnings estimates, the market will see issuers miss analyst estimates more often and by a wider margin.127 When companies miss analyst estimates, their stock prices fall drastically.128

Even before Regulation FD took effect, its impact started to hit the market.129 Bulldog Research, a firm that tracks analyst performance on estimates and recommendations issued a survey in the end of 2000.130 It reflects a 5.3% decrease in analyst accuracy from second-quarter 2000

122. Id.
123. Levitt, Open Commission Meeting, supra note 41.
125. Id.
126. Levitt, Open Commission Meeting, supra note 39.
128. Id.
129. See id.
130. Id.
earnings to third-quarter 2000 earnings. Additionally, “flash estimates” – estimates changed by analysts in the four weeks before earnings are announced – grew more dispersed by 13.67%. Bulldog Research’s Co-President, Mike Thompson believes Regulation FD is behind this notable change. The study covered the time period after adoption but before the effective date of Regulation FD. It seems that even in anticipation of the regulation, analyst estimates diverged from each other and the accuracy of estimates decreased.

Most of the comment letters opposing Regulation FD predicted a “chilling” effect on corporate communications. It seems, however, that companies are disclosing more information and at a quicker pace. This rapid-fire disclosure also has its drawbacks because the market will often react before analysts or individual investors have time to assess what the disclosure really means for the company and its prospects for success.

At first blush the statement that Regulation FD will increase volatility may not seem to square with the Efficient Capital Market Hypothesis. As stated earlier, however, the hypothesis is imperfect and there is a window (albeit very narrow) before all public information is accurately reflected in the stock price. The effect of Regulation FD will be to amplify the volatility in stock prices during that very narrow window. Thus, a stock will experience higher highs and lower lows before adjusting to the price equilibrium.

Naturally, those who trade quickest have an opportunity to profit, but others will lose out. Regulation FD does not take away from market professionals the institutional edge to react quicker to or trade quicker on market information than individual investors. Individual investors may have access to the information, but will not be able to act on it before the price adjusts. It did not take long for a few victims to emerge in the post Regulation FD world. Intel and Gateway are two examples.

One day after Intel announced lower than expected third-quarter revenue, its stock price fell twenty-two percent. Even more stunning was Gateway’s late announcement that the computer manufacturer

131. Id.
132. Id. The “dispersion” referred to in the flash estimate study indicates the variance among analysts estimates, not variance between an analyst’s flash estimate and company reported earnings.
133. Id.
134. Id.
135. Id.
138. Securities and Exchange Commission Comm’r Laura S. Unger, Fallout from Regulation
would miss earnings forecasts by forty percent.\textsuperscript{139} Gateway’s stock price dropped a staggering thirty-six percent.\textsuperscript{140} Gateway’s incident occurred just nine days after its chief financial officer reassured investors that Gateway was confident with consensus earnings per-share estimates; a response to counter sliding stock prices after an analyst downgraded Gateway’s stock.\textsuperscript{141} An analyst who follows Gateway for ING Barings, Rob Cihra, suspects Regulation FD may be prompting companies to disclose bad news sooner.\textsuperscript{142}

Volatility continued into the fourth-quarter of 2000 with earnings warnings sending the major averages careening lower.\textsuperscript{143} According to Chuck Hill, research director for First Call/Thomson Financial, the recent surge in profit downgrades by companies and the analysts who track them has been both sudden and severe.\textsuperscript{144} Fourth quarter 2000 pre-announcements jumped fifty-eight percent over the previous year.\textsuperscript{145} Hill ascribed part of this increase to Regulation FD, which he says has led companies with market-moving earnings news to disclose it more quickly than in the past.\textsuperscript{146} “I’d advise people to buckle their seat belts . . . because they could be in for a wild time,” said Hill regarding fourth-quarter earnings.\textsuperscript{147} While Regulation FD cannot be blamed for what seems to be a slowing down of the economy, it certainly seems to have contributed to the decline. While numerous factors unrelated to Regulation FD affect earnings, the effect of the regulation is likely reflected in the spread between analyst estimates and reported earnings. This is because companies can no longer “walk the Street down.”\textsuperscript{148}

Another troubling effect of Regulation FD is the cost incurred by issuers to ensure compliance. The SEC predicted a per year total cost of approximately $34,937,500 to $49,562,500 in the adopting release.\textsuperscript{149} Other organizations, however, have estimated costs far exceeding the


\textsuperscript{140} Id.

\textsuperscript{141} Id.

\textsuperscript{142} Id.

\textsuperscript{143} Id.

\textsuperscript{144} Id.

\textsuperscript{145} Id.

\textsuperscript{146} Id.

\textsuperscript{147} Id.

\textsuperscript{148} Walker, \textit{supra} note 55.

\textsuperscript{149} The SEC based its calculation on an assumed five Regulation FD-related disclosures per issuer affected by Regulation FD (13,000) at a cost of $85 per hour for in-house staff (estimated twenty-five percent of workload) and an outside counsel cost of $175 per hour (estimated seventy-five percent of workload). Additionally, the SEC assumed a five-hour burden per filing to arrive at a per-filing cost ranging from $537.50 to $762.50. The SEC did not factor in any one-time
SEC’s estimates. For example, the Securities Industry Association expects issuer costs to total $297 million. SIA attributed $87 million dollars of that estimate to the one-time cost of creating Regulation FD-related procedures and the remaining $210 million for Year-One costs of determining the materiality of and disseminating information.

Perhaps the most expensive Regulation FD-related cost may come from private securities litigation. Despite the SEC’s express statement that a Regulation FD violation is not deemed a violation of the antifraud provisions, plaintiff lawyers are already developing Regulation FD-related theories for antifraud liability. Some plaintiff lawyers have stated that the SEC, whether intentionally or not, provided a roadmap for private enforcement efforts in the related regulation commentary. In attempts to comply with Regulation FD, issuers will most likely list whatever information the company believes to be material. Although the company may err on the side of caution by including information it may not necessarily believe is material, plaintiffs’ lawyers may use the internal lists and policies in order to have the information deemed material. Additionally, many issuers have stated in 8-K filings that the disclosure is made pursuant to Regulation FD. Some lawyers will argue that if the disclosure was made pursuant to Regulation FD, then it must be material. Another likely vehicle for private actions is a shareholder derivative suit alleging management was negligent in implementing and enforcing the company’s obligations under Regulation FD as well as internal company policies. In addition, an issuer’s contacts with analysts may lead to liability under the “entanglement” or “adoption” theories. Finally, disclosures made under Regulation FD are still subject to Rule 10b-5 liability. If predictions concerning stock price volatility hold true, then Regulation FD may not only provide for more private causes of action, but also support higher damage calculations. The possibility of increased private actions due to Regulation

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150. **Securities Industry Association, Costs and Benefits of Regulation Fair Disclosure** 14 (May 2001). According to SIA, these calculations are based on the 7,906 issuers listed on exchanges with the volume and cost data culled from interviews with twenty-five general counsel, SEC filing data, Thomson First Call data, and discussions with multiple web-casting vendors and Investor Relations professionals (hereinafter SIA, Costs and Benefits of FD).

151. *id.*


153. *id.* at 18.


155. *id.* at 16.

156. *id.* at 15.

157. *id.*

158. *id.* at 19.
FD is real and significant.

With such extensive costs or potential costs, what benefits do the regulation provide that tip the cost/benefit scale to the side of adopting the regulation? It seems the most touted benefit is a perceived leveling of the playing field. This benefit, however, will likely prove illusory or mask a negative consequence considering the large number of investors that rely on brokers and the 88 million investors who own equity mutual funds.\textsuperscript{159} The fact that so many individual investors rely on institutions undermines the arguments that selective disclosure adversely affects individual investors. Actually, these investors may ultimately bear the brunt of any negative consequences to the extent that brokers and fund managers rely on the research and recommendations produced by sell-side analysts.\textsuperscript{160}

VI. Conclusion

The SEC passed Regulation FD because it believed selective disclosure undermined investor confidence in the market. Is the cure worse than the disease? It is still too early to tell because the side effects of the regulation may be amplified in the short term by knee-jerk reactions.

This rule, intended to ensure investor confidence in the market, could fundamentally alter the relationships in and the functions of the market. By placing its regulatory priority on parity of information rather than efficiency of the market, the SEC may actually undermine investor confidence in the market due to increased volatility and reduced quality of disclosed information. In truth, only time will tell. Enough concerns were raised about the regulation and enough alternatives suggested, however, that the SEC should have exhausted other means before adopting such a far-reaching regulation.

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\textsuperscript{159} SIA, Costs and Benefits of FD, supra note 150, at 16-17.

\textsuperscript{160} Id.

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