Regulation FD: SEC Tells Corporate Insiders to “Chill Out”

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INTRODUCTION

The investing community should prepare for a new Ice Age.[1] On October 23, 2000, Regulation FD (Reg FD)[2] went into effect,[3] and its application is going to freeze the running rivers of information from corporations to the public.[4] This result is not to say that Reg FD is the first securities regulation enacted either in the United States or abroad. It is just one of the latest securities regulations in a complex system that governs on the Federal, State, and Self Regulatory Organization (SRO) levels.[5]

As early as 1776, when Thomas Jefferson put quill to parchment

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1. Not to be confused with any environmental disaster some politicians would have us believe is at hand. *See* AL GORE, EARTH IN THE BALANCE (1992).

2. 17 C.F.R. § 243.100 (2000).

3. Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (to be codified at 17 C.F.R. pt. 240, 247, and 249).

4. Although the internet has made it possible for individuals to trade without assistance, market professionals are still a necessary piece in the capital markets puzzle. As of July 2001, 5,571 firms with 87,765 branch offices and 683,241 registered representatives were registered with the National Association of Securities Dealers (NASD). An increase in all but one of these categories occurred over the last year, at the end of which there were 5,579 member firms, 82,726 branch offices, and 672,489 registered representatives, dispelling any theories that the internet made the stockbroker an anachronism. *NASD Regulation Statistics*, *at* http://www.nasdr.com /2380.htm (last visited Sept. 4, 2001).

5. Self Regulatory Organizations (SROs) are entities that have federal approval from the SEC to self-regulate under the umbrella of both federal disclosure laws and state merit-based regulation. The two most widely known SROs are the NASD and the New York Stock Exchange (NYSE). Others are the American Stock Exchange, Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, International Stock Exchange, NASDAQ, NASDR (formerly part of NASD), Pacific Exchange, Philadelphia Stock Exchange, Municipal Securities Rulemaking Board, Depository Trust Company, Mortgage Backed Securities Clearing Corporation, National Securities Clearing Corporation, and Options Clearing Corporation. *See generally* http://www.sec.gov/ (last visited Jan. 8, 2002).

and Adam Smith published *Wealth of Nations*,[6] a long tradition of Anglo-American securities regulation existed.[7] American capitalists

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6. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 456 (R.H. Campbell & A.S. Skinner eds., Claredon Press 1976) (1776).

7. In 1696, the English Parliament passed a law prohibiting stock price manipulation commenting:

> The pernicious Art of Stock-Jobbing hath, of late, so wholly perverted the End and Design of Companies and Corporations, erected for the introducing, or carrying on, of Manufactures to be the Private Profit of the first Projectors, that the Privileges granted to them have, commonly, been made no other Use of, by the first Procurers and Subscribers, but to sell again, with Advantage, to ignorant Men, drawn in by the Reputation falsely raised, and artfully spread, concerning the thriving State of their Stock.

11 H.C.J. 595 (1696), *reprinted in* 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3-4 (3d ed. 1989).

Although securities regulation developed in England as early as the seventheenth century, securities were not traded in North America on a large scale until the mid-eighteenth century. STUART BANNER, ANGLO-AMERICAN SECURITIES REGULATION 122 (1998). During the American Revolution, food shortages allowed for speculation; however, nothing was really done about it. "One early nineteenth-century commentator, looking back on the preceding century, observed that although forestalling, engrossing, and regrating had always been common law crimes in North America, 'notorious violations have often been complained of, but scarcely in any instances prosecuted.'" *Id*. at 123.

Although the United States did not regulate the sale of securities or speculation in general during its early years, it did have the same cultural condemnation of speculation and gambling as in England. *Id.* at 125. Merchants who did nothing but make internal sales that did not involve any outside economy were looked upon as leaches that only increased internal costs at the expense of the consumer:

> Eighteenth century Americans also inherited the prevailing English conception of the economy, according to which the national wealth was increased only by the production and by selling goods abroad, not by internal trade. The merchants who bought and sold in domestic markets were thus understood to contribute nothing to the public good.

Id. at 124. While economists and politicians reflected this rhetoric, the colonial legislatures were mostly silent. In fact, the Massachusetts colonial legislature repealed two English anti-speculation statutes they adopted earlier in the seventeenth century. *Id.* at 126-27.

The United States may have been a late bloomer as far as comprehensive, formal securities regulation, but Americans have always had a general suspicion of those who profit at the expense of others. *Id.* at 175. William Smith stated:

> What useful Art is promoted? What Manufactures are carried on? Or what Addition is there made by it top the public Stock and Wealth of a People? None certainly. For the Whole of Gaming is only to shift the Property and Specie, which hath been acquired to a Country and brought in by the honest Labourer's Industry, from one Hand to another.

WILLIAM SMITH, THE SINFULNESS AND PERNICIOUS NATURE OF GAMING 13 (1752), *reprinted in* BANNER, *supra*, at 125. Another commenter said this of stockjobbers:

> A set of sharks, that flouncing in the flood,

have betrayed Smith's "invisible hand,"[8] by developing and codifying regulations, principally in the twentieth century with the 1933 Securities Act,[9] its cousin, the Securities Exchange Act of 1934,[10] and the various state securities statutes known as "blue sky" laws.[11] Reg FD purportedly furthers the goals of the Federal securities laws, which seek to maintain competitive and fair markets through the free flow of all information regarding all publicly traded corporations.[12]

The need to target selective disclosure by regulation is closely related to the recent increase in individual investing in public

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> Suppose all kind of fish their proper food:
> A set of hawks, that flying in the air,
> Of harmless birds make up their bill of fare:
> A set of wolves, that prowling 'bout for prey,
> All animals devour that cross their way.

Id. at 147-48.

This attitude, combined with the expansion of the American economy in the mid-nineteenth century, necessitated a departure from laissez-faire economics and a measure of regulation. *See id*. at 222-49.

8. SMITH, *supra* note 6, at 456. Smith stated in full:

> By preferring the support of domestick [sic] to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the publick [sic] good.

Id.

9. 15 U.S.C. § 77 (2000).

10. 15 U.S.C. § 78 (2000).

11. Not surprisingly, the phrase "blue sky" came from *the* hotbed of securities trading in the Midwest: Kansas. In the Kansas State legislature, during discussion of the first major merit-based securities regulation of securities and those who sold them, a congressman stood up and stated there were crooks who "'would sell building lots in the blue sky in fee simple.'" LOSS & SELIGMAN, *supra* note 6, at 27.

Although every State securities statute varies in many details, most have adopted some variation on the Uniform Securities Act, first passed in 1956:

> With 36 states, the District of Columbia, Guam, and Puerto Rico having adopted or substantially adopted the 1956 Uniform Securities Act, there is a great deal more uniformity in state securities regulation that there was before the 1956 Act. Before that Act, no two state securities statutes came close to being identical.

Id. at 40. Since State securities regulations are not affected or augmented by Reg FD, this quote will be the extent of the discussion.

12. *See infra* note 45.

markets. Often, individuals are trading either on their own research through brokers or on internet trading sites with proprietary research. These unsophisticated investors are the victims of selective disclosure because information is usually selectively disclosed to market professionals. The professionals can trade on information before it becomes publicly available to these dilettante investors. Thus far, insider trading laws have constituted the regulation of selective disclosure.[13] These laws, however, only touch the demand factor of the equation rather than the supply factor. Reg FD is a supply-side regulation that allows for administrative enforcement action by the Securities Exchange Commission (SEC).[14]

According to a divided SEC,[15] this regulation is a natural complement to the existing insider trading rules because it punishes the tipper in all situations, regardless of whether the tippee trades on the provided information.[16] With every periodic disclosure regulation, however, the SEC walks the fine line between creating an even playing field by allowing equal access to material information and stifling the information output due to corporate insiders fear of prosecution. Thus far, the SEC has been successful in regulating material information disclosure because insiders have known the clear lines they could not cross. This Note proposes that Reg FD has greatly blurred those lines to the detriment of the entire securities industry.

Part I of this Note describes selective disclosure and the history of securities regulation to date. It focuses primarily on federal insider trading rules under the 1934 Act because those rules constituted the sole deterrent to selective disclosure prior to Reg FD. Part I concludes by explaining, in full, the specific provisions of Reg FD.

Part II of this Note analyzes exactly why Reg FD will do more harm than good. This Note explains why Reg FD will create a freeze on information, and why, in a practical sense, analysts and large institutional investors will still have access to material nonpublic

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13. *See infra* Part I.B.
14. *See infra* Part I.C.
15. *Selective Disclosure Rule Gains Approval by Divided SEC*, 32 Sec. Reg. & L. Rep. (BNA) 1089 (Aug. 14, 2000); *see infra* note 86.
16. *See infra* Part I.C.

information. Lastly, Part III of this Note delineates what the SEC should have enacted in place of Reg FD.

I. BEFORE THE FREEZE: THE HISTORY OF SELECTIVE DISCLOSURE AND RELEVANT SECURITY REGULATIONS

A. Selective Disclosure, Then and Now

Before explaining the pertinent securities regulations, it is necessary to understand the target of Reg FD, selective disclosure. Simply, when a corporate insider, such as a director or an officer, gives nonpublic information to an individual, he selectively disclosed that information. Of course, not all selective disclosure of information is damaging. Rather, the information must be material.[17] Material information is any information that an investor would consider important when deciding whether to buy or to sell a security.[18]

In 1929, the United States was nearing the end of more than a decade of uninterrupted prosperity and peace. Unlike today, however, common Americans invested in a largely *unregulated* New York Stock Exchange.[19] In September of that year, the market began a

17. Due to the infinite wisdom of the SEC, Reg FD only covers "material nonpublic information." 17 C.F.R. § 243.100(a) (2001).

18. In Reg FD, information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in the purchase or sale of a security. 17 C.F.R. § 243.100 (2001). This definition is the identical definition of materiality as used in Rule 10b-5 fraud cases. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

19. "By the 1820s, the New York Stock and Exchange Board encompassed a miniature private legal system, which formulated rules governing the market and resolved disputes involving members." BANNER, *supra* note 7, at 250. The foxes ran the chicken coup.

The main function of the Board was the compilation of member credit information and the matching of buyers and sellers. *Id*. at 258-61. This merit-based regulation only extended to the stocks traded by Board members. *Id*. at 264-66. Any sanctions by the Board were few and far between since it was such a close-knit family:

> The greatest punishment the Board could impose was the suspension or expulsion of members, but this power could of course be exercised only over members, and the number of members was never very large. From the perspective of any given member, therefore, the number of potential trading partners provided by the Board's ability to expel defaulters was a small one. At a time when the Board consisted of fifty brokers, for instance, it may have been possible for any one of the brokers to know each of the other forty-nine personally. If so, the Board's enforcement mechanism may not have provided him with much additional security.

downward spiral that did not stop until 1932 and fueled the Great Depression.[20] Congressional hearings ensued over the causes of the market's decline and possible remedies to forestall its recurrence; selective disclosure was one of the hot topics.[21]

In the pre-federal regulation days, selective disclosure took an almost incestual form.[22] Large investment banking houses such as

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Id. at 263-64. Even in the depths of the Depression, President Herbert Hoover was still reluctant to regulate federally the securities market. In response to statements made by then Governor Roosevelt, he stated, "'The Governor does not inform the American people that there is no Federal law of regulation of the sale of securities and that there is doubtful constitutional authority for such a law; . . . New York State . . . has such authority.'" JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 18-19 (1995).

20. The market devastation was unprecedented:

> Between September 1, 1929, and July 1, 1932, the value of all stocks listed on the New York Stock Exchange shrank from a total of nearly $90 billion to just under $16 billion–a loss of 83 percent. In a comparable period, bonds listed on the New York Stock Exchange declined from a value of $49 billion to $31 billion. "The annals of finance," the Senate Banking Committee would write, "present no counterpart to this enormous decline in security prices." Nor did these figures, staggering as they were, fully gauge the extent of the 1929-1932 stock market crash. During the post-World War I decade, approximately $50 billion of new securities were sold in the United States. Approximately half or $25 billion would prove near or totally valueless. Leading "blue chip" securities, including General Electric, Sears, Roebuck, and U.S. Steel common stock, would lose over 90 percent of their value . . . .

Id. at 1-2.

21. The Senate Committee on Banking and Currency made pre-regulation findings on defects in the securities markets. S. REP. NO. 73-1455 (1934) *reprinted in* COMMITTEE ON BANKING AND CURRENCY, 72ND CONG., S. Res. 84 (1934). In its report, the Committee found that the deficiencies in information flow were not just due to lack of reporting of periodic information, but also because the Exchanges did not require material information in the listing documents. "Although the New York Stock Exchange has proclaimed the searching nature of its listing requirements, evidence was adduced before the subcommittee establishing that the exchange authorities were lax in their investigation of listing applications." *Id*. at 70.

Not only were listed companies lax in reporting, but the unlisted companies had no reporting requirements at all. This lack of reporting allowed corporate insiders and the investment houses involved with them to horde information. These unlisted securities represented the majority of traded securities on the market and compounded the reporting deficiencies:

> On December 31, 1933, 355 stocks and 19 bonds were 'listed' on the New York Curb Exchange as compared with 1,069 stocks and 620 bonds in the 'unlisted department.' As of November 23, 1933, 82 percent of all the securities traded on the New York Curb Exchange were in the 'unlisted' department. The value of the 'unlisted' securities was . . . approximately $17,000,000.00.

Id. at 90-113. Additionally, the investment bankers played a heavy role in keeping information from the public, instead trading on the accounts of preferred clientele. *Id*.

22. The report states:

J.P. Morgan & Co.[23] and National City, Co.[24] had close ties to the publicly traded corporations on the New York Stock Exchange.[25]

> The partners of J.P. Morgan & Co. and Drexel & Co. held 126 directorships and trusteeships in 89 companies, excluding subsidiaries, with $19,929,396,475.39 total resources for 75 of these companies. These directorships included 20 directorships on 15 banks and trusts companies . . .; 14 directorships on 7 miscellaneous holding companies . . .; 9 directorships on 5 utility holding companies . . .; 10 directorships on 8 utility operating companies . . .; 12 directorships on 10 railroad companies . . .; 55 directorships on 38 industrial companies . . .; and 6 directorships on 6 insurance companies . . . .

Id. at 385-86.

23. Perhaps the biggest coup during the Congressional hearings was the testimony of J.P. Morgan, head of the then "largest private banking house in the world." *Id.* at 84.

24. National City Co., the investment banking subsidiary of the National City Bank of New York, was involved in one of the largest scams causing the downfall of the market: the Peruvian foreign bond scam. This scam is one of the most blatant abuses of selective disclosure to this day. In this case, the investment bankers who issued the debt securities possessed knowledge that was not transmitted to the public in the offering prospectus.

Before the majority of the $65,000,000 in bonds had been offered to the public and quickly absorbed, an almost humorous memo was sent to Charles Mitchell from J.H. Durell, the vice president and overseas manager of the bank. None of the pathetic financial statistics contained in the letter were reflected in the prospectus. The prospectus only stated, "The Republic of Peru is the third largest country in South America, with an area of approximately 550,000 square miles. It has a population estimated at 6,000,000." *Id*. at 129. Notice there is no mention of the fact that Peru had paid nearly none of its foreign obligations, had a struggling economy, and could not balance its budget! *Id*. at 126-29.

After the final issue of the series, the total sale valued $90 million. At roughly the same time as the issue, another internal memo stated that the "[e]conomic conditions of the country leave considerable [sic] to be desired. The last cotton crop was a short one on account of lack of water for proper irrigation." *Id*. at 131. In the end, the Peruvian government defaulted on all three issues, which, initially valued at over $90 per bond, traded at under $5 by the time of the hearings. *Id*.

25. Congress stated, "A prolific source of evil has been the affiliated investment companies of large commercial banks." *Id*. at 113. These large banking houses, J.P. Morgan, Kuhn, Loeb & Co., and National City, had the ability to spin off bad securities on commercial investors, thereby making almost all of their undertakings fool proof. Additionally, they were the source of *all* large-scale credit and investment, making themselves indispensable to large corporations.

Kuhn, Loeb & Co. had particularly close ties to the rail industry, and not coincidentally, many of its "preferred clients" were directors and officers of those same railroads:

> Mr. Pecora [counsel for the subcommittee]. I would say in casually glancing over this list that a large number if not a majority of the names appearing thereon are the names of men who were executive officers of various railroad corporations.
>
> Mr. Kahn. Railroad and other corporations; yes.
>
> Mr. Pecora. And most of the railroad corporations with which these men were affiliated are railroad corporations for which your firm did financing, are they not?
>
> Mr. Kahn. Yes.

These large banks had access to material nonpublic information because they had huge leverage on the corporations due to their control on credit. In this tight-knit family, the large brokerage houses gathered information before it filtered down to the public. Investment banks then used this information to trade on the accounts of preferred stockholders, which included powerful politicians, entertainers, and even sports heroes.[26] In the securities industry, information is power, and those with the information have never been particularly

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> Mr. Pecora. Did your firm handle issues that found their way into the portfolio of large insurance companies?
>
> Mr. Kahn. Yes, sir.
>
> Mr. Pecora. I notice among the names on this list that of Mr. F.H. Ecker, president and director of the Metropolitan Life Insurance Co.
>
> Mr. Kahn. Yes.
>
> Mr. Pecora. That is one of the largest insurance companies in the country, isn't it?
>
> Mr. Kahn. It is; yes.
>
> Mr. Pecora. If not in the world?
>
> Mr. Kahn. Yes.
>
> Mr. Pecora. And has perhaps the largest cash resources of the entire country?
>
> Mr. Kahn. I think so.
>
> Mr. Pecora. And hence is the largest potential buyer of railroad bonds?
>
> Mr. Kahn. I think so.

Id. at 106.

26. Note that the idea of "fair disclosure" is to level the playing field, and allow any diligent investor to be on even footing. The preferred lists of the investment banking houses were the most blatant violation "fair disclosure." Not only were the most powerful financial magnates controlling the information, but they also used it to trade for huge profits on the accounts of the most well-known and respected people in the United States. *Id*. at 101.

With respect to J.P. Morgan, Congress examined the sale of Allegheny Corporation stock. It was offered to a group of preferred investors at cost, $20 per share. The Chairman of the National Democratic Committee, John J. Raskob, brought 2,000 shares and others are as follows:

> Joseph Nutt, treasurer of the Republican National Committee- 3,000 shares; Charles Francis Adams, Secretary of the Navy- 1,000 shares; Edmund Machold, speaker of the Assembly of the State of New York and State chairman of the Republican Party in New York State- 2,000 shares; Silas H. Strawn, president of the United States Chamber of Commerce and president of the American Bar Association- 1,000 shares; William Woodin, president of American Car and Foundry Co. and later Secretary of the Treasury- 1,000 shares.

Id. at 102. These individuals made a profit of over $37 per share in five months. *Id*. at 103. A second offering made to the preferred list included the personal broker for Calvin Coolidge and Bernard Baruch. *Id*.

interested in giving it to those without. Of course, this situation put the general public at an incredible disadvantage and greatly contributed to the market's crash.

Today, selective disclosure is much more insidious. No longer can the common investor point to the tycoon on the block such as J.P. Morgan.[27] Due to the decentralized structure of the securities markets,[28] selective disclosure pervades every region of the United States and every facet of those markets.[29] Computer technology and the internet facilitated much of this change, exposing the common investor more than ever to the markets' vicissitude.[30]

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27. *See NASD Regulations Statistics, supra* note 4.

28. Now literally anyone with a computer and some cash in his pocket can invest over the internet:

> The Internet offers virtually instantaneous, worldwide access to millions of users and has radically transformed the securities industry. Individual, retail investors now can obtain real time market information, trade at low cost using an online brokerage, and have access to information that previously was available only to industry professionals and money managers. Moreover, investors are now more involved in the everyday management of their accounts than ever before.

Robert B. Robbins, *Regulation of Online Securities Transactions, in* SECURITIES LAW FOR NONSECURITIES LAWYERS, SE62 A.L.I.-A.B.A. 445, 447 (June 1, 2000).

29. A major vehicle of selective disclosure is the conference call. Corporate directors sponsor these calls and historically invite only institutional investors and analysts to participate:

> A 1998 study by the National Investors Relations Institute (NIRI) noted that 83% of NIRI companies conduct analyst conference calls. Moreover, a 1999 survey by the Association for Investment Management and Research (AIMR) found that 95% of polled financial analysts and portfolio managers regarded conference calls as the most informative of technology-aided communications, outstripping even company websites.
>
> . . . According to the NIRI study, which surveyed 268 companies that solicited participation in their conference calls, 99% invited buy-side analysts and 94% invited institutional shareholders, while only 29% invited individual shareholders and a mere 14% invited the media. As of March 1999, only 3% of NIRI-identified companies made transcripts of conference calls available to the public.

Daniel J. Kramer, *Speaking to the Market Under Sec's Proposed Rules*, *at* http://www.srz.com/pubtemplate.asp?id=112 (last visited Aug. 31, 2001).

The significance of these statistics is evident considering over 5,600 firms and 665,000 representatives are registered with the NASD. *See NASD Regulations Statistics, supra* note 4. Literally tens, if not hundreds, of thousands of market professionals are engaged in conference calls tailored specifically to the few analysts that follow a particular security. *Id.* This practice excludes the multitude of investors.

30. The Securities Industry Association (SIA) surveyed American securities firms in order to see exactly the magnitude and importance of the internet in the expansion of the securities markets. SIA found that "North American securities firms spent more than US$11 billion on

For instance, suppose Jim is an analyst in Kansas that follows XYZ Corporation, a small regional corporation traded on the Over the Counter Bulletin Board. Jim is the only analyst that follows XYZ, and therefore the investing public relies solely upon his research report. The chief financial officer (CFO) of XYZ has lunch with Jim at a burger joint in Hays, Kansas. Jim asks how quarterly earnings look. The CFO smiles and nods. That response is selective disclosure. No longer is it *necessarily* J.P. Morgan and Henry Ford discussing earnings reports.[31]

The SEC and the individual investor present three major arguments against selective disclosure. First, selective disclosure, much like insider trading, works against individual retail investors. Second, not only does it injure investors already in the market, but also it deters prospective investors from participating in purportedly "free markets." Third, selective disclosure "aids and abets" in the conversion of corporate information into a commodity, and allows

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technology in 1996." SIA, *Technology Trends in the Securities Industry: Spending, Strategies, Challenges, & Change–1999*, *at* http://www.sia.com/ surveys/html/ tech_ trends_sample.html (last visited Aug. 31, 2001).

Unfortunately, widespread access to information over the internet also invites fraud and especially targets the unsophisticated investor. Robert B. Robbins of Shaw Pittman in Washington D.C. writes:

> In general, the Securities and Exchange Commission . . . has welcomed the Internet as a positive development that enables the Commission to better achieve its goals of increasing market transparency and increasing investor access to information. However, the Commission has expressed concern that the tremendous proliferation of information and increased participation in the securities markets increases the opportunity for securities fraud.

Robbins, *supra* note 28, at 447.

31. *Necessarily* is the key term. Generally, the greatest culprit of possible selective disclosure are widely traded large firms, usually tracked by the largest securities firms. *See generally* Bethany McLean, *You're Not Invited*, FORTUNE, Apr. 26, 1999, at 464 (analyzing recent blatant examples of selective disclosure including Northern Telecom and Compaq. She writes, "In late February a group of big investors paid a visit to Compaq's Houston headquarters, where the CFO acknowledged that yes, there was some softness in the PC industry. The next day the stock crashed 14%--no doubt puzzling the investors who weren't there."); Paul Commins, *Selective Disclosure Exposed at EDS*, *at* http://wwww.fool.com/ news/2000/foth000615.htm (last visited Aug. 31, 2001) (explaining the selective disclosure of EDS earnings reports to Merrill Lynch analyst Stephen McClellan); *What is "Selective Disclosure?" Why Do Some Firms Play Favorites in Revealing News?*, *at* http://www. thehamptonreport.com/selectve_disclosure.htm (last visited Aug. 31, 2001) (outlining selective disclosure by insiders of Clorox Co., Wal-Mart Stores, Apple Computer, and Abercrombie & Fitch Co.).

corporations to exercise significant control over analysts.

Primarily, selective disclosure theoretically works against the common investor by granting a monopoly to research analysts and institutional investors on corporate information.[32] With this information, common sense dictates that traders will trade to the benefit of their customers and to the detriment of lay people.[33] Thus, in many situations, selective disclosure is an essential counterpart to insider trading. Another side effect of this unfairness is the loss of investor confidence in the fairness of the markets, thereby causing a withdrawal of capital from the market, and overall market contraction.[34]

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32. In their primer for Regulation FD, 10b5-1 and 10b5-2, James Hamilton and Ted Trautmann write:

> The SEC had become increasingly concerned about the corporate community's selective disclosure of material information. As reflected in publicized reports, many companies were disclosing important nonpublic information, such as advance warnings of earnings results, to securities analysts or selected institutional investors or both, before making full disclosure of the same information to the general public.

JAMES HAMILTON, J.D., LL.M. & TED TRAUTMANN, J.D., FAIR DISCLOSURE AND INSIDER TRADING REFORMS: REGULATION FD, RULE 10B5-1 AND RULE 10B5-2 (CCH) ¶ 101, at 7 (2000).

33. The SEC, in the adoption release stated:

> As reflected in recent publicized reports, many issuers are disclosing important nonpublic information, such as advance warnings of earnings results, to securities analysts or selected institutional investors or both, before making full disclosure of the same information to the general public. Where this has happened, those who were privy to the information beforehand were able to make a profit or avoid a loss at the expense of those kept in the dark.

Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, 73 SEC Docket (CCH) at 3 (Aug. 15, 2000). Therefore, allowance of selective disclosure can be perceived as a loophole in the general prohibition against insider trading. *See* Paul B. Brountas Jr., *Note: Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts*, 92 COLUM. L. REV. 1517, 1529 (1992).

34. Again, the SEC states:

> . . . [T]he practice of selective disclosure leads to a loss of investor confidence in the integrity of our capital markets. Investors who see a security's price change dramatically and only later are given access to the information responsible for that move rightly question whether they are in a level playing field with market insiders.
> . . . [I]nvestors lose confidence in the fairness of the markets when they know that other participants may exploit "unerodable informational advantages" derived not from hard work or insights, but from their access to corporate insiders.

Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, 73 SEC Docket (CCH) at 3-4 (Aug. 15, 2000).

For example, in response to the proposal release for Reg FD,[35] the Commission received nearly 6,000 comment letters, most from individual investors applauding the regulation.[36] One investor exemplified the retail investor's position, writing, "Yes!!!! Please level the playing field for the little guy."[37] Additionally, the North American Securities Administrators Association (NASAA), an organization that represents the various state securities commissioners by advocating and developing both state and federal regulations, heralds Reg FD as a victory for the individual investor.[38]

This perceived inherent unfairness leads not only to investor suspicion, but also to nonparticipation in the market by possible investors.[39] Constant influx of capital is the lifeblood of the market; hence, it is necessary to entice new people into the market. People are more willing to gamble their money when ensured they are on a level playing field with professional investors.[40] Many regulators,

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35. Selective Disclosure and Insider Trading, Exchange Act Release No. 42,259, 71 SEC Docket (CCH) at 732 (Jan. 31, 2000). The SEC solicits comments in its proposal releases in order to amend and focus proposals before adoption. *Id.*

36. Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, 73 SEC Docket (CCH) at 4 (Aug. 15, 2000).

37. Comment Letter of Michael Fulara to SEC website, *at* http://www.sec.gov/rules/proposed/s73199/fulara1.txt (last visited Aug. 31, 2001). Mr. Fulara goes on to explain:

> Pursue this new rule with all your passion. For years I have been frustrated at seeing an analyst was given proprietary company information that was selectively distributed to their client base, causing a significant move in a stock. As recent as this week, a stock I own declined significantly for no known reason. Since the decline I found out that an analyst cut their earnings estimate on the company SIGNIFICANTLY for the current quarter. There were no public indications that anything had changed at the company. About a week after the analyst's downgrade, the company announced that quarterly earnings would [sic] effected by accounting problems. . .. Give 'em hell guys!

Id.

38. Comment Letter of Bradley W. Skolnik on behalf of the North American Securities Administrator Association to SEC website, *at* http://www.sec.gov/rules/proposed/s73199/skolnik1.htm (last visited Sept. 2, 2001). Mr. Skolnik writes, "In today's fast-moving and Internet-driven economy, it is important to level the playing field between the investing public and those who have traditionally been privy to and gatekeepers for material nonpublic information regarding publicly traded companies." *Id.*

39. "The investing public has a legitimate expectation that the prices of actively traded securities reflect publicly available information about the issuer of such securities . . . . [T]he small investor will be—and has been—reluctant to invest in the market if he feels it is rigged against him." Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, 73 SEC Docket (CCH) at 4 n.6 (Aug. 15, 2000) (quoting H.R. REP. NO. 100-910 (1988)).

40. *See* Skolnik, *supra* at note 38.

including former SEC Chairman Levitt, consider this an important requirement for the future of the federal securities markets.[41]

Lastly, allowing corporate directors to control the information supply converts information from a free good into a commodity.[42] The SEC is particularly concerned with this possibility because commodifying information leads to exclusion in the dispersion of information and perpetuates and effectively magnifies selective disclosure.[43] As soon as information becomes a commodity, corporations possess leverage to grant access to information to only those who will post positive reports and possibly hide negative information.[44] This reaction not only creates more stratified access to information, but also breeds the possibility of fraud.

B. Present Relevant Federal Regulations

In response to a 1934 mandate from President Franklin D. Roosevelt,[45] the U.S. Congress began the process of supplementing

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41. "'High quality and timely information is the lifeblood of strong, vibrant markets,' Levitt declared . . .. He predicted that Regulation FD will bring all investors, regardless 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.'" *Selective Disclosure Rule Gains Approval by Divided SEC*, *supra* note 15.

42. "Regulation FD is also designed to address another threat to the integrity of our markets: 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." Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, 73 SEC Docket CCH at 3 (Aug. 15, 2000).

43. The SEC is "concerned, in this regard, with reports that analysts who publish negative views of an issuer are sometimes excluded by that issuer from calls and meetings to which other analysts are invited." *Id.*

44. "In the absence of a prohibition on selective disclosure, 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." *Id.*

45. F.D.R. wrote on February 9, 1934:

> In my message to you last March proposing legislation for Federal supervision of national traffic in investment securities I said: 'This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt with on exchanges.'
>
> This Congress has performed a useful service in regulating the investment business on the part of financial houses and in protecting the investing public in its acquisition of securities.
>
> There remains the fact, however, that outside the field of legitimate investment,

the existing Securities Act of 1933[46] with the Securities Exchange Act of 1934.[47] These two legislative directives complement each other. The 1933 Act regulates the distribution of securities,[48] while the 1934 Act regulates the secondary trading of securities through the exchanges.[49] While both Acts preclude disclosure, the 1934 Act, more specifically, § 10[50] and corresponding Rule 10b-5,[51] the

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> naked speculation has been made far too alluring and far too easy for those who could and for those who could not afford to gamble.
>
> Such speculation has run the scale from the individual who has risked his pay envelop [sic] or his meager savings on margin transaction[s] involving stocks with whose true value he was wholly unfamiliar, to the pool of individuals or corporations with large resources, often not their own, which sought by manipulation to raise or depress market quotations far out of line with reason, all of this resulting in loss to the average investor, who is of necessity personally uninformed.
>
> . . . It is my belief that exchanges for dealing in securities and commodities are necessary and of definite value to our commercial and agricultural life. Nevertheless, it should be our national policy to restrict, as far as possible, the use of the exchanges for purely speculative operations.
>
> I, therefore, recommend to the Congress the enactment of legislation providing for the regulation by the Federal Government of the operations of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and, so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation.

H.R. REP. NO. 73-1383 (Apr. 27, 1934), *reprinted in* 78 CONG. REC. 7701, 7702 (1934).

46. 15 U.S.C. § 77 (1933).

47. 15 U.S.C. § 78 (1934).

48. Every distribution of securities, if not subject to an exemption, must be registered according to § 5 of the 1933 Act:

> (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly-
>
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such a security through the use or medium of any prospectus or otherwise; or
>
> (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

15 U.S.C. § 77 (1933).

49. The preface of the Securities Exchange Bill of 1934 states:

> The Committee on Interstate and Foreign Commerce, to whom was referred the bill (H.R. 9323) to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and trough the mails, to prevent inequitable and unfair practices on such exchanges and markets . . . .

H.R. REP. NO. 73-1383 (Apr. 27, 1934), *reprinted in* 78 CONG. REC. 7701 (1934).

50. 15 U.S.C. § 78j (1934).

51. 17 C.F.R. § 240.10b-5 (1951).

Exchange Act's general anti-fraud provision, particularly prohibit selective disclosure.[52]

Although it seems at first blush that § 16[53] of the 1934 Act covers insider trading, this assumption is in fact incorrect.[54] Due to judicial creation, Rule 10b-5 promulgated under § 10 of the Act has become one of the most important features of federal securities regulation and, before Reg FD, the only deterrent to selective disclosure.

Federal insider trading regulations attempt to regulate the demand of material nonpublic information by prohibiting trading on the information. This attempt, however, is unclear in the language of § 10(b), which simply prohibits the use of any "manipulative or deceptive device."[55] Nor does Rule 10b-5, promulgated thereunder,

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52. The 1933 Act regulates selective disclosure only during the initial distribution of the security by regulating the types of communications allowed before the initial distribution. "Before the actual distribution period, the only communication used is the prospectus made in accordance with section 10 of the 1933 Act or a 'red herring' prospectus allowed before the distribution period begins. The prospectus is one of various types of registration statements available under the Act and mandated under section 6 of the Act."

The 1933 Act's disclosure provisions will not be discussed in this Note, because the SEC stated that it will not interfere with the disclosure requirements of the 1933 Act. Specifically, the SEC stated:

> In response to concerns about the interplay of Regulation FD with the Securities Act disclosure regime, we have expressly excluded from the scope of the regulation communications made in connection with most securities offerings registered under the Securities Act. We believe that the Securities Act already accomplishes most of the policy goals of Regulation FD for purposes of registered offerings . . . .

Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, 73 SEC Docket (CCH) at 7 (Aug. 15, 2001).

53. 15 U.S.C. § 78p (1934).

54. Section 16(b) states:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any periods of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period of six months.

15 U.S.C. § 78p(b).

55. In full:

> Sec. 10. It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any

state anything about insider trading or the use of material nonpublic information.[56] An extensive base of case law, however, turned 10b-5 into the de facto anti-fraud rule of the Securities Exchange Act. In *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[57] the Court connected fraud and insider trading: "[I]nherent unfairness [is] involved where one takes advantage" of "information intended to be available only for a corporate purpose and not for the personal benefit of anyone."[58]

In *Dirks v. SEC*,[59] the Supreme Court decided the prototypical case involving selective disclosure of material nonpublic information by a former officer to a securities analyst.[60] The Court first repeated the insider trading requirement developed in a previous case, *United*

> national securities exchange-
>
> (a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j.

56. Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

57. 43 S.E.C. 933 (1968).

58. *Id*. at 936.

59. 463 U.S. 646 (1983).

60. Defendant was an officer at a New York brokerage house, and he received information from a former officer of an insurance company outlining the insurance company's undisclosed fraud. Defendant investigated the claims and found that there was a possibility that the fraud was being committed. *Id*. at 648-49.

In the course of his investigation, he discussed the company with a number of clients and investors who dumped the stock after hearing of the fraud. Five investment advisers, the defendant's colleagues, sold over $16 million of the security. *Id*. at 649.

States v. Chiarella,[61] that the offender breached a fiduciary duty. The Court held that Raymond Dirks' actions did not in fact violate Rule 10b-5[62] because he neither breached a fiduciary duty nor did his actions involve a manipulation or deception.[63]

The classical tipper-tippee relationship is not the only theory of liability under Rule 10b-5. In *United States v. O'Hagan*,[64] the Court enunciated the "misappropriation theory," holding that liability for insider trading must involve a deception at the source.[65] The SEC

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61. 445 U.S. 222 (1980).

62. A former employee of Equity Funding of America informed Mr. Dirks that the corporation may be fraudulently overstating its assets. While investigating the matter, Dirks discussed the issue with other brokers and clients who consequently traded on the information, which later turned out to be true. Neither Dirks nor his employer traded in the security of Equity Funding. *Dirks*, 463 U.S. at 648-49.

63. The SEC failed to establish that Dirks was a fiduciary of the shareholders. Justice Powell commented:

> This requirement of a specific relationship between the shareholders and the individual trading on inside information has created analytical difficulties for the SEC and courts in policing tippees who trade on inside information. Unlike insiders who have independent fiduciary duties to both the corporation and its shareholders, the typical tippee has no such relationships.

Id. at 655. Justice Powell concluded:

> Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee *and* the tippee knows or should know that there has been a breach.

Id. at 660 (emphasis added).

The Court states that outsiders such as Dirks may become insiders in certain circumstances and implicitly accept the according fiduciary duty. "When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee." *Id*. at 655 n.14. This rule alleviates the problem of proving the duty of loyalty and the knowledge of the inappropriateness of trading on the information.

64. 521 U.S. 642 (1997).

65. Justice Ginsburg writes:

> The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information . . . . Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.

also addressed concerns about the ambiguity of who owes a duty of confidentiality[66] and whether mere possession of material nonpublic information at the time of trading suffices as insider trading.[67] The regulations promulgated under § 10 constantly evolve to regulate the demand for insider information,[68] and Reg FD, which seeks to limit the supply of material nonpublic information, is a natural compliment.

C. Reg FD

Reg FD comprehensively restricts selective disclosure of material nonpublic information by issuers.[69] If the issuer intentionally[70] selectively discloses material nonpublic information, he must publicly disclose the information "simultaneously";[71] if the selective disclosure is unintentional, the consequent public disclosure must be made "promptly"[72] to avoid a violation.[73] To satisfy "public

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Id. at 652.

66. 17 C.F.R. § 240.10b5-2 (2000). Rule 10b5-2 responds to the ambiguity of "duty of trust or confidence" under *O'Hagan*.

67. 17 C.F.R. § 240.10b5-1 (2001). This Rule officially ends the possession versus use debate for inside information following the Eleventh Circuit in *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998).

68. For a discussion of the insider trading regime after *O'Hagan*, see Roberta S. Karmel, *Outsider Trading on Confidential Information–A Breach in Search of a Duty*, 20 CARDOZA L. REV. 83 (Sept. 1998).

69. 17 C.F.R. § 243.100 (2001). The crux of Reg FD states:

> § 243.100 General rule regarding selective disclosure
> (a) Whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any person described in paragraph (b)(1) of this section, the issuer shall make public disclosure of that information as provided in § 243.101(e) . . ..

Id.

70. 17 C.F.R. § 243.101(a) states, "A selective disclosure of material nonpublic information is 'intentional' when the person making the disclosure either knows, or is reckless in not knowing, that the information he or she is communicating is both material and nonpublic."

71. 17 C.F.R. § 243.100(a)(1).

72. 17 C.F.R. § 243.101(d).

> "Promptly" means 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 (or, in the case of a closed-end investment company, a senior official of the issuer's investment adviser) learns that there has been a non-intentional disclosure by the issuer or person acting on behalf of

disclosure," the issuer may either file a Form 8-K with the SEC[74] or disseminate "the information through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public."[75]

Reg FD applies to disclosures of information to broker-dealers (and associates thereof),[76] investment advisers or institutional investment advisers (and associates thereof),[77] investment companies (and affiliated persons),[78] and owners of the issuer's securities, "under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information."[79] Highlighting the symbiotic nature of Reg FD and Rule 10b-5, the regulation expressly states that it does not apply to communications made to those bound by a "duty of trust or confidence to the issuer"[80] or to those who expressly agree to maintain confidentiality.[81]

Much like Rule 10b-5, Reg FD fails to mention causes of action. The SEC has made it quite clear that it does not intend for there to be

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> the issuer of information that the senior official knows, or is reckless in not knowing, is both material and nonpublic.

Id.

73. 17 C.F.R. § 243.100(a)(2).

74. 17 C.F.R. § 243.101(e)(1).

75. *Id*. § 243.101(e)(2). In the adoption release, the SEC offered a myriad of disclosure procedures that together would satisfy the alternate disclosure standard:

> 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.

Securities Act of 1933, Exchange Act Release No. 43,154, 73 SEC Docket (CCH) at 14 (Aug. 15, 2001).

76. 17 C.F.R. § 243.100(b)(1)(i).

77. *Id*. § 243.100(b)(1)(ii).

78. *Id*. § 243.100(b)(1)(iii).

79. *Id*. § 243.100(b)(1)(iv).

80. *Id*. § 243.100(b)(2)(i).

81. *Id*. § 243.100(b)(2)(ii).

a private cause of action associated with Reg FD.[82] Additionally, failure to publicly disclose does not alone create a cause of action under Rule 10b-5 which allows for civil liability.[83]

II. IS IT GETTING COLD IN HERE?: THE FAILURES OF REG FD

The investment community sinks or swims in the water of information on publicly and privately traded securities. For former Chairman Levitt, those with the better boats had a comparable advantage over individual investors who get swallowed up in these rapids. His solution, Reg FD, is to calm those waters, but in doing so, he is imposing a freeze that will have an adverse effect on all yachtsmen on the sea of investment.[84]

A. Ambiguity

The most glaring problem with Reg FD is the lack of a bright-line test for materiality with which corporate insiders can govern their disclosure policies. Although there is a loose definition of what is material, this is of no comfort to those officers forced to make literally hundreds of disclosures per year. The SEC gives some guidance as to examples of material information,[85] but a non-

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82. Securities Act of 1933, Exchange Act Release No. 43,154, 73 SEC Docket (CCH) at 6-7 (Aug. 19, 2001); *see also* 17 C.F.R. § 243.102.

83. 17 C.F.R. § 243.102. "No failure to make a public disclosure required solely by § 243.100 shall be deemed to be a violation of Rule 10b-5 (17 CFR 240.10b-5) under the Securities Exchange Act." *Id.*

84. *See infra* Part II, A-D.

85. The adoption release states:

> While it is not possible to create an exhaustive list, the following items are some types of information or events that should be reviewed carefully to determine whether they are material: (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 for securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of securities holders, public or private sales of additional securities; and (7) bankruptcies or receiverships.

Securities Act of 1933, Exchange Act Release No. 43,154, 73 SEC Docket (CCH) at 11 (Aug.

exhaustive list does not help those who expose themselves to possible litigation every time they speak to an analyst.

Commissioner Unger cited this as one of her major objections to the regulation, and echoed the concern that this will have severely adverse effects on the flow of information to the marketplace.[86] Unlike Unger, the remainder of the SEC, seems to disregard the possible issuer frustrations with this Reg FD.[87]

If the SEC appears skeptical about the feasibility of Reg FD, their hesitation pales in comparison to the legal and professional investing community's criticism. Both sectors are convinced that the ambiguity of Reg FD will create such paranoia in issuers that the running streams of information will permanently freeze.

The professional investing community has been the most ardent critic of Reg FD. This criticism is to be expected because Reg FD further restricts the community's access to information and limits their exploitation of the personal ties they developed with issuers over the years. Although these comments must be viewed skeptically, that community does have a unique perspective on the probable effects of the Regulation. Merrill Lynch & Co., Inc. sided with Commissioner Unger in stating that Reg FD will be absolutely counterproductive in its goal of providing fair information access to the public due to the ambiguity of many terms in Reg FD, most

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15, 2001).

86. The Securities Regulation and Law Report wrote at the passage of Reg FD:

> Unger–who voted in December 1999 to issue the rule proposal despite misgivings–continued to object, questioning whether new Regulation FD "will . . . provide the information investors really want." Saying "parity of information is not the same as integrity of information," she told BNA that in her view, "the rule is broader than the problem." Unger, the sole Republican commissioner among three Democrats, also commented that "putting myself in the shoes of corporate management, I would not be sure what is or is not material."

Selective Disclosure Rule Gains Approval by Divided SEC, supra note 15.

87. The adoption release states:

> While we acknowledged in the Proposing Release that materiality judgments can be difficult, we do not believe an appropriate answer to this difficulty is to set forth a bright-line test, or an exclusive list of "material" items for purposes of Regulation FD . . . . [T]he general materiality standard has always been understood to encompass the necessary flexibility to fit the circumstances of each case.

Securities Exchange Act of 1933, Exchange Act Release No. 43,154, 73 SEC Docket (CCH) at 10-11 (Aug. 15, 2001).

importantly "materiality."[88]

Charles Schwab & Co., Inc. is also concerned with the ambiguity of Reg FD, but it applauds the general effort.[89] It realizes that there are disparities in information and that equal information for all could mean more efficient markets. Schwab states, however, that without clarification, Reg FD will push issuers into a paranoia that will chill the information flow.[90]

On the legal side, Sullivan & Cromwell, one of the largest New York securities law firms, was particularly critical of Reg FD in its comment letter to the SEC. It sees Reg FD as imposing another layer of regulation that will merely cloud the well-reasoned decision in *Dirks*.[91] Stephen Shulte, on behalf of the New York Bar Association, wrote that the burdensome nature of determining what is "material"

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88. Merrill Lynch writes:

> Our fundamental concern with Regulation FD is its overwhelming reliance on "materiality," a concept that can only be defined in general terms as something that a reasonable investor would want to know. The fact is that few lawyers will even opine on materiality issues that come up in informal communications between issuers and analysts because different lawyers, judges, juries, and regulators will apply the standard differently in similar circumstances . . . . The amorphous nature of materiality judgments was a major part of the reason that the Supreme Court in *Dirks* rejected the Commission's proposed standard for insider trading liability, and insisted that to avoid deterring valuable communications between issuers and analysts, the SEC must find not only materiality but also that the insider had disclosed the information for an improper purpose.

Comment Letter from Merrill Lynch & Co., Inc. to, Jonathan Katz, Secretary of the Securities and Exchange Commission (May 5, 2000), *at* http://www.sec.gov/rules/proposed/s73199/morales1.htm.

89. *See* Comment Letter from Charles Schwab & Co., Inc. to Jonthan Katz, Secretary of the Securities and Exchange Commission (Apr. 20, 2000), *at* http://www.sec.gov/rules /proposed /s73199/callcot1.htm.

90. *Id*.

91. The comment letter states:

> We are, therefore, concerned that the Commission's initiative to implement . . . an immediate public disclosure requirement . . . . [It] will serve only to reimpose on issuers, analysts and investors the same uncertainties about line-drawing that prevailed prior to *Dirks*, and this uncertainty may substantially constrict the flow of information to the public to the detriment of investors. The parity of information sought by the Commission may in fact become a parity of non-information (or perhaps even of misinformation).

Comment Letter from Sullivan & Cromwell to Jonathan Katz, Secretary of the Securities Exchange Commission (Apr. 28, 2000), *at* http://www.sec.gov/rules/proposed/s73199/sulcromz.htm.

will prevent much information from ever getting to the public.[92]

Another attorney, Donald Meiers, warned that a general unwillingness of issuers to speak to the press will exacerbate this chilling of information.[93] As a result, Reg FD's ambiguity will chill the speech of issuers. The costs of this regulation are magnified by the fact that it is not only the business world that is terrified of it, but also the lawyers who advise on compliance.

So the brokerage houses, analysts, and lawyers are concerned about Reg FD's ambiguous language chilling the speech of corporate insiders. These parties, however, are not Reg FD's target. Rather, Reg FD is directed at corporations, and a survey taken soon after Reg

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92. He writes:

> Under Regulation FD, private discussions with analysts . . . would become impractical from a compliance standpoint. An issuer would need to evaluate each and every discussion both before it took place, to assure that the issuer's representative would be adequately prepared to avoid what could be argued was an intentional material nonpublic disclosure, and after it took place, to evaluate whether any non-intentional material nonpublic disclosure was made and, if so, issue a prompt public disclosure. Compliance problems would be particularly burdensome in light of what we believe is an overly broad definition of "person acting on behalf of an issuer." By encompassing any officer, director, employee or agent . . . the Regulation would create an unwieldy compliance problem for large issuers.

Comment Letter from Steven Shulte on behalf of the New York Bar Association to Jonathan Katz, Secretary of the Securities Exchange Commission (Apr. 28, 2000), *at* http://www.sec.gov/rules/ proposed/s73199/schulte1.htm.

93. Rachel Witmer, *Lawyer Suggests Efrects Regulation FD Might Have on Media*, 32 Sec. Reg. & L. Rep. (BNA) 1485 (Oct. 30, 2001). Rachel Witmer reports that a combination of factors will limit the media's access to corporate information:

> the media's access to authorized company spokespersons will likely be more limited, as companies limit the number of such spokespersons;
>
> members of the media might be treated as if they were analysts or other persons covered by Regulation FD to cover the risk, for example, that an analyst is present at a press briefing;
>
> local media outlets might receive less information from corporate officials, as companies seek to make the broad "public disclosure" specified in the rule;
>
> members of the print media – which cannot effect simultaneous public disclosure – might receive less information from corporate officials than prior to Regulation FD; and
>
> generally, corporations will try to exert more control over getting their message out, by seeking to control more closely the content and timing of its publication in the media. They might also put more reliance on their own communications, such as broadcast e-mails, than on speaking through the media.

Id.

FD's proposal found that 42% of corporate investor relations officials would limit communications![94]

Admittedly, when the large brokerage houses voice opposition to a regulation that directly affects their ability to get information to the public and, more importantly, industry cronies, the criticism is fairly biased. Conversely, when the law firms who stand to benefit from Reg FD in the form of increased compliance costs and possible litigation speak out against its language, the signal is clear. A primary function of a lawyer is to interpret regulations and statutes, and if the best law firms in the country see problematic language, changes are due.

B. Unrealistic

Reg FD fails to accept the twin realities of selective disclosure: (1) selective disclosure is an important avenue for information to get to the public; and (2) many issuers who are dependent upon powerful analysts will have to give good information for favorable reports.

The SEC made great strides in getting regular reports to the public in its EDGAR[95] database; however, much information is still leaked to the public through the thousands of analysts and brokers that take the time to develop personal contacts with corporate insiders. The most notable example of this leak is the analyst's research report on corporations. Information in these reports is oftentimes gained through selective disclosure. The SEC's heavy-handed reasoning that public disclosure is possible or advantageous in all situations is fundamentally flawed.[96] Due to the crucial function of analyst reports

94. A survey of 462 corporate investor relations officials indicated that 42% would probably limit their communications if the proposed rule were adopted. *SEC Outlaws Selective Disclosure Over Brokerage House Objections*, INVESTOR'S BUS. DAILY, Aug. 11, 2000, at A7.

95. The Electronic Data Gathering and Retrieval (EDGAR) is a database of all SEC filings and can be accessed via the SEC Web site. *See* http://www.sec.gov (last visited Sept. 9, 2001); http://www. freeedgar.com (last visited Sept. 9, 2001).

96. Note that the SEC has a tradition of underestimating the importance of the analyst vis-à-vis its own regulations. Homer Kripke, in his work outlining the several flaws of the SEC, writes:

> Although the view of the statute is that the ordinary prospective investor can make an intelligent investment decision from a prospectus, the staff has shown over the years that it does not really believe this. On the contrary, the staff feels bound to do the investor's thinking and verifying for him. This in practice has meant filtering out

in the public's information gathering process, crippling the analyst's ability to gain information will in fact hurt the group the SEC is trying to assist—the public.

Probably, the most important feature of an analyst's research report is the earnings forecast for the next few quarters. In the past, either privately or during conference calls, firms leaked information to analysts who then create an accurate earnings forecast for the public. This disclosure cushions the impact of earnings reports by forewarning investors of any surprises before the issuer announces them. However, with Reg FD, issuers may not transmit this information to analysts and no warnings can be given. The market reflects the consequences of Reg FD in all sectors, from Cisco in the tech sector[97] to Alcoa in heavy industry.[98]

> everything but the objective facts, as if the investor could not focus a suitable skepticism on estimates of value or projections of future earnings . . . .
>
> On the other hand, the SEC overestimates the average investor's ability to master the complexities of the financial picture of the typical issuer . . . , and therefore has failed . . . at least until recently to understand that [this information] can be used only effectively by professionals.

HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE 14 (1979).

97. The market saw the detrimental effects of the Reg FD prohibitions in the early months of 2001. Cisco Systems is a heavily traded tech stock on the NASDAQ market under the ticker symbol CSCO. Cisco released its second quarter earnings after trading ended on February 6, 2001. Cisco reported earnings per share of $0.12 per share versus $0.11 per share for the second quarter of 2000. *Cisco Systems Reports Second Quarter Earnings*, *at* http://newsroom.cisco.com/dlls/corp-020601.html (last visited Sept. 9, 2001). Although the figures were positive and Cisco made the earnings amidst multiple acquisitions that siphoned away capital, the figure missed analysts' estimates by one penny per share. *Id*. The stock price reflected a negative and immediate response by the investing community. In after-hours trading on February 6, the stock price fell $1.86 to $33.86 after gaining $1.19 during that day's trading hours before the figure was released. Carol Vinzant, *Nasdaq Edges Up; Dow Gain is Erased*, WASH. POST, Feb. 7, 2001, at E3.

On February 7, 2001, the stock dropped to 31.063 per share trading 281,548,700 shares! *See* http://www.nasdaq.com (last visited Feb. 5, 2002). The next largest volume figure traded on January 10, 2001, and it was almost 70 million shares less than the February 7 number. *Id*. To give one an idea of sheer amount of shares traded, over 11,172 shares changed hands every second on February 7, 2001! This kind of volatility is not good for any investor, institutional, or individual.

98. Analysis speculate that Alcoa's concern about complying with 'fair disclosure' regulations caused the company to cease providing guidance in earnings forecasts. The company's stock fell 10% on the news that earnings would fall short of expectations after being on target for the prior eight years. Robert McGough, *The Big Chill: Street Feels Effects of 'Fair Disclosure' Rule–Clamming Up? Some See Alcoa Adopting the Silent Treatment*, WALL ST. J., Oct. 23, 2000, at C1.

This blindness to the essential place of selective disclosure in the analyst's research has another side. Contrary to the SEC's position,[99] Reg FD disregards the fact that many corporate insiders are beholden to analysts that follow them for positive and thorough reports. Therefore, corporate insiders are put in a difficult position when they are forced to choose between violating Reg FD and compromising the welfare of the security on the market.[100] Hence, compliance with Reg FD may entail too great a cost for the corporate insiders of many smaller publicly traded corporations, and in looking out for the best interests of the corporation, they may choose to violate the regulation.

Lastly, this regulation ignores the fact that many forms of selective disclosure will be nearly impossible to detect. Technically, a mere gesture may be selective disclosure of material nonpublic information, but if it occurs between two people in the basement of a building, no one will know.[101] Without insider trading, there is no real evidence unless someone will voluntarily testify, which is highly unlikely due to possible self-incrimination.

C. Inconsistent with Prior SEC Policy

The SEC always stresses that all investors should be placed on an equal footing, but it never admits that there should be the "parity of information" that Reg FD mandates. In fact, the Supreme Court in *Dirks* reiterated the then–current SEC view that absolute equality of information is untenable and unhealthy for the markets.[102]

99. *See supra* notes 43 & 44.

100. At a D.C. panel discussing the compliance aspects of Reg FD, many lawyers insisted that because the penalty is on the issuer, the analysts would still attempt to use connections to get information. Roger Patterson, a lawyer for Wilmer, Cutler & Pickering stated, "Analysts are going to continue to put pressure on issuers to get the information they need." Rachel Witmer, *Despite SEC Disclosure Rule, Lawyer Says, Analsysts, Firm Officials Will Talk One-On-One*, 32 Sec. Reg. & L. Rep. (BNA) 1452, M53 (Oct. 23, 2000).

101. At the same D.C. Bar Association panel Manny Strauss, Associate General Counsel for Columbia Energy Group, stated that "[a]lthough it will be more risky for public companies' officials to speak one-on-one with securities industry analysts once [Reg FD] goes into effect . . ., such communications are not likely to disappear." *Id*. He went on to say, "'I just don't see one-on-ones disappearing. I think the risk associated with them is increasing.'" Id.

102. 463 U.S. at 646, 658 (1983). The Court states:

> The SEC expressly recognized that "[the] value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by

Chairwoman Unger, in her dissent to the Reg FD echoed this concern over the inconsistency with prior policy.[103] In addition to the Commissioner, but also the group that represents the industry professionals, the Securities Industry Association (SIA), expresses the same concern.[104]

D. Conclusion: A Fine Balance?

In the adoption of Reg FD, the SEC stated that "Regulation FD strikes an appropriate balance."[105] In its opinion, the possible benefits of Reg FD more than offset the costs; however, it is evident that the SEC misjudged both the high costs and nearly non-existent benefits.[106]

> [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors." 21 S.E.C. Docket, at 1406. The SEC asserts that analysts remain free to obtain from management corporate information for purposes of "filling in the 'intersticas in analysis' . . . ."

Id. at 659 n17.

103. *Selective Disclosure Rule Gains Approval by Divided SEC, supra* note 15. Commissioner Unger questioned whether Regulation FD would provide the information investors really want saying "parity of information is not the same as integrity of information," and that "the rule is broader than the problem." *Id*.

104. "In its April 6 letter, SIA maintained that neither the 1933 Securities Act nor the 1934 Securities Exchange Act 'contemplates the unattainable goal of parity of access to all material information relevant to the issuer that is available anyplace outside the issuer.'" *SIA Says SEC Proposal to Stem Leaks to Analysts Cannot Work As Intended,* 32 Sec. Reg. & L. Rep. (BNA) 532 (Apr. 24, 2000).

105. Securities Exchange Act of 1933, Exchange Act Release No. 43,154, 73 SEC Docket (CCH) at 7 (Aug. 15, 2001).

106. The problems with Reg FD can be summarized in the closing remarks of a 1977 address by Dean Manning to the American Bar Association:

> To declare a law is very cheap; to administer or enforce a law is very expensive.
> The secondary costs of a law are often greater than the direct costs.
> The capacity of law to change human behavior is very limited.
> Even where a law may effectively achieve its primary purpose, the side effects may be too great and too negative to permit or warrant its adoption.
> Many problems are not amenable to legal solutions at all.
> . . . Our legislators, judges, administrators and the public—all of us—must come to understand that law is in fact an instrument of limited utility, is always accompanied by significant, and frequently harmful, side effects, and that it is very expensive . . . .

KRIPKE, *supra* note 96, at xvi.

III. PROPOSAL: BREAK THE ICE PACK

No one argues that former Chairman Levitt's intentions with Reg FD were not genuine and well-founded. Theoretically, equal access to information may be a good thing. The fears of acting Chairwoman Unger, however, are more meritorious. Part II of this Note analyzed the severe drawbacks of Reg FD. Ambiguity, almost willful blindness to reality and inconsistency with prior SEC policy comprise a very strong case against Reg FD as it stands. The solution to this is simple: rescission of Reg FD.

Two variables point to this solution. First, Arthur Levitt, the former SEC Chairman that championed Reg FD, is gone. Former Chairman Levitt stepped down from his position on February 9, 2001.[107] As the longest reigning SEC Chairman, Arthur Levitt guided the SEC through the securities markets' recent explosive growth.[108] His long reign and success, however, do not excuse the deficiencies in Reg FD. The acting SEC Chairwoman, Laura Unger,[109] was a staunch opponent of the Reg FD during its passage.[110] She will be an able lieutenant to incoming Chairman Harvey Pitt[111] whom, at his confirmation hearing, emphasized his belief in less regulation of the securities markets.[112] Additionally, with respect to Reg FD

107. *Securities and Exchange Commission: Bush Designates SEC's Unger Acting Chairman of Commission*, 33 Sec. Reg. & L. Rep. (BNA) 237 (Feb. 19, 2001).

108. *SEC Chairman Arthur Levitt to Step Down Before Mid-February*, 32 Sec. Reg. & L. Rep. (BNA) 1741 (Dec. 25, 2000). Arthur Levitt served the country well for over nearly 8 years, being appointed in July 1993. Former President Clinton expressed his appreciation:

> "This time of unprecedented growth has brought new and unique challenges to America's markets, and Arthur Levitt led the SEC's response to the forces of technology, competition, and globalization," Clinton stated. "America's capital markets and its investors have benefited significantly from Chairman Levitt's enduring vision, judicious oversight, and abiding sense of fair play," the President related.

Id.

109. February 12, 2001, President Bush named Unger as the acting Chairman of the SEC until he nominates and the Senate confirms the permanent Chairman. *Securities and Exchange Commission: Bush Designates SEC's Unger Acting Chairman of Commission*, *supra* note 107.

110. *See Selective Disclosure Rule Gains Approval by Divided SEC*, *supra* note 15.

111. The Senate confirmed Chairman Pitt's nomination on August 2, 2001; however, he has yet to take over from acting Chairman Unger. *S.E.C. Chief Confirmed*, N.Y. TIMES, Aug. 2, 2001, at C4.

112. *Id.* "He said securities laws must be reviewed because many . . . impose an unfair burden on market participants." *Id*.

specifically, he stated that he "'might have suggested changes or taken a different approach' if he'd been involved in writing the rule."[113] Aiding these two with a plan of deregulation is the retirement of liberal Democrat Norman Johnson.[114] The retirement leaves two slots vacant ready for Commissioners who share Unger's and Pitt's more conservative view.

Second, not only is the political climate ripe for rescission of Reg FD, but the regulatory landscape does not necessitate Reg FD. The SEC adopted Reg FD to regulate supply rather than demand as a compliment to the well-established and constantly evolving breadth of insider trading law. In fact, adopted with Reg FD were two new rules to fill in the case law created gaps of Rule 10b-5.[115] The genius of Rule 10b-5 is that it regulates the demand for material nonpublic information by punishing the detrimental use of it in insider trading. By allowing for the transfer of information without fear on the issuer's part, the rivers of information can flow unimpeded.

IV. CONCLUSION: WARMER DAYS AHEAD

Former Chairman Levitt led the SEC through its most exciting times and helped it adapt to the changing economic landscape. Still, the passage of Reg FD was a mistake. With Chairman Pitt at the helm of the SEC and Laura Unger supporting him, the time is right rescind Reg FD. Its rescission will allow analysts access to information they deserve as market professionals, and it will give corporate insiders peace of mind. The most important outcome will be the transformation of information ice into information water powering the "hydro-economic" machine known as capital markets.

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113. *SEC Nominee Looking at Changing Rules*, CHI. SUN-TIMES, July 20, 2001, at 55.

114. *See Securities and Exchange Commission: Bush Designates SEC's Unger Acting Chairman of Commission*, *supra* note 107.

115. *See supra* notes 66 & 67.