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# BOUNCING THE TIGHTROPE: THE S.E.C. ATTACKS SELECTIVE DISCLOSURE, BUT PROVIDES LITTLE STABILITY FOR ANALYSTS

J. Scott Colesanti, LL.M.\*

## INTRODUCTION

Indisputably, discussions between corporate officers and financial analysts are fraught with peril, and the confrontation itself has been popularized as “a fencing match conducted on a tightrope.”<sup>1</sup> At the less glamorous end of that tightrope is the analyst. Expected to draw “oohs” and “ahs,” yet unforgiven for stumbling, he walks the wire above the abyss of Rule 10b-5 (“10b-5”)<sup>2</sup> litigation every time he creates a report, relays an announcement, or simply makes a recommendation after meeting with management.<sup>3</sup>

With new insider trading schemes catapulting that crime back onto page one of the newspapers, and regulators and laymen alike fearing its unknown proportions,<sup>4</sup> the Securities and Exchange Commission (“S.E.C.” or “Commission”) on December 20, 1999 released for comment a series of proposed new rules (“Proposal”).<sup>5</sup> The rule with the most immediate impact

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1. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980) (citing *S.E.C. v. Bausch & Lomb, Inc.*, 565 F.2d 8, 9 (2d Cir. 1977)) (“Bausch & Lomb”).

2. 17 C.F.R. § 240.10b-5 (1999) (promulgated pursuant to Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1994)) (“Exchange Act”).

3. This article does not address the unsympathetic circumstances surrounding the analyst who, after obtaining a private audience with corporate management, uses the disclosed information to trade for her own benefit. See, e.g., *S.E.C. v. Moran*, 922 F. Supp. 867 (S.D.N.Y. 1996).

4. See, Thor Valdmanis & Tom Lowry, *Wall Street's New Breed Revives Inside Trading*, USA TODAY, Nov. 4, 1999, at 1B, available in 1999 WL 6857615.

5. Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590 (1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, and 249) (proposed Dec. 20, 1999). Two of the proposed rules, Rule 10b5-1 and Rule 10b5-2 address, respectively, the unsettled issues in inside information cases of (a) whether the S.E.C. must prove that a defendant charged with violating 10b-5 “used” (as opposed to simply proving he was in “*knowing possession*” of) inside information and (b) “what types of family or other non-business relationships” can form the basis for liability “under the misappropriation theory of insider trading.” *Id.* at 72,591 (emphasis added). The proposed new concept of 10b5-1, that a defendant is liable if trading while *aware* of material nonpublic information, would hopefully end the “use” versus “possession” debate. See, Dennis J. Block and Jonathan M. Hoff, *Insider Trading:*

was Regulation FD (i.e., “Fair Disclosure”), which mandated that an issuer quickly act to broadly disseminate comments made, either intentionally or inadvertently, to a small audience (i.e., during a teleconference, private interview, or informal meeting).<sup>6</sup> After much controversy and debate, Regulation FD was formally adopted by the Commission on August 10<sup>th</sup> of 2000 and became effective on October 23rd.<sup>7</sup>

Citing various recent studies setting forth the baleful effects of “selective disclosure,”<sup>8</sup> the S.E.C. outright declared war on the process. However, a necessary casualty of that war is the financial analyst. Indeed, a diminished role in the new Millennium is anticipated for Wall Street’s economists, as is bluntly stated in (1) the Proposal (“[a]lthough analysts play an important role in gathering and analyzing information, and disseminating their analysis to investors, we do not believe that allowing issuers to disclose material information selectively to analysts is in the best interests of investors or the securities markets generally.”),<sup>9</sup> and (2) the Final Release (“Whereas issuers once may have had to rely on analysts to serve as information intermediaries, issuers can now use a variety of methods to communicate directly with the market.”)<sup>10</sup>

Within a month of its release of the Proposal, the S.E.C. received scores of supportive comments from both individuals and institutional investors alike.<sup>11</sup> Focusing on Regulation FD’s remedial spirit, these comments ranged from the polite and appreciative (“I applaud your efforts to level the playing field . . . .”)<sup>12</sup> to the frustrated and plaintive (“Do your job! . . . Give hard-

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*Use v. Possession*, 220 N.Y.L.J. 5 (1998). As for proposed rule 10b5-2, it relates to the “misappropriation theory” used by the S.E.C. to prosecute “outsiders” (i.e., traders who are not employees or directors) since the early 1980s. The theory was officially upheld by the Supreme Court for the first time in 1997. *United States v. O’Hagan*, 521 U.S. 642 (1997) (partner in law firm convicted of violating, *inter alia*, Rule 10b-5 for trading in the stocks and options of a company to be acquired by his law firm’s client).

6. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,591.

7. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,715 (2000) (to be codified at 17 C.F.R. pts. 240, 243, and 249) (“Final Release”).

8. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,591-92. For purposes of this article, “selective disclosure” is defined as any disclosure of material news by an issuer to a group smaller than the general public.

9. *Id.* at 72,591.

10. Final Release at 51,717.

11. A copy of the Comments to the Proposed Rule on Selective Disclosure and Insider Trading can be found at <<http://www.sec.gov/rules/s73199.htm>>. The authors of comments on Regulations FD submitted to the S.E.C., either supportive or critical, are referred to herein generally as “Commentators.”

12. Comments of Tom Winberry, Jan. 24, 2000, available at <<http://www.sec.gov/rules/s73199/winberr1.txt>>.

working people who get their money by ‘earning it’ an even break with the fixers of Wall Street.”).<sup>13</sup> But these comments ignored the fact that the courts, as well as the S.E.C., have consistently endorsed the beneficial “screening” role of analysts.<sup>14</sup> Moreover, lacking much guidance in the area of selective disclosure, these same courts often frustrate the cause of disclosure by indirectly chilling corporate discussions in refusing to dismiss professionals such as analysts and corporate officials from ubiquitous civil 10b–5 actions.<sup>15</sup>

S.E.C. Chairman Arthur Levitt was passionate about outlawing selective disclosure, which he publicly labeled a “stain upon our market.”<sup>16</sup> Indeed, the Chairman’s shotgun approach to eliminating the practice alternatively decried analysts’ alleged lack of disclosure “about their firms’ close relationships with the companies they follow,”<sup>17</sup> their unique status as recipients of material information,<sup>18</sup> and their allegedly biased and inaccurate analysis.<sup>19</sup> Accordingly, after extending the comment period and receiving nearly 6,000

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13. Comments of P. Mattingly, Jan. 24, 2000, available at <<http://www.sec.gov/rules/s73199/mattingl.txt>>. In a similar vein are the comments submitted the same day by Glenn M. Welt, “1 private investor”: “Small investors are being left in the dark till the big boys make their moves.” A copy of these comments can be found at <<http://www.sec.gov/rules/s73199/weltl.txt>>. Conversely, the Securities Industry Association (“SIA”) has formally filed with the Commission, its opposition to Regulation FD on various grounds, including the proposed regulation’s chilling effect on corporate disclosure, its possible abridgment of First Amendment rights, and its eradication of the necessary function of analysts to “screen, distill, and evaluate ‘raw’ information.” See, Comment Letter from Stuart J. Kaswell, SIA Senior Vice President and General Counsel, to Jonathan G. Katz, Secretary, S.E.C. (Feb. 24, 2000), *reprinted at* <[http://www.sia.com/legal\\_regulatory/html/proposed\\_regulation.html](http://www.sia.com/legal_regulatory/html/proposed_regulation.html)> (visited Apr. 1, 2000). On March 22, 2000, the S.E.C. extended the comment period on Regulation FD until April 28, 2000. Selective Disclosure and Insider Trading, 65 Fed. Reg. 16,160 (2000) (to be codified at 17 C.F.R. pts. 230, 240, 243, and 249). See also, Lynn Hume, *Johnson Leaving S.E.C.; Extra Time for Disclosure Feedback*, THE BOND BUYER, Mar. 23, 2000, at 6.
  14. See *infra* notes 127 and 138.
  15. Approximately 755 securities class actions were filed between 1996 and 1999. Securities Class Action Clearinghouse, Stanford University School of Law website (visited Feb. 21, 2000) <<http://www.securities.stanford.edu/stats.htm>>. Approximately 90 cases alleging fraud under the Exchange Act were filed between October 1999 and February 2000 alone. Search of LEXIS, Docket Library, USCIVL File (Feb. 23, 2000).
  16. Floyd Norris, *Wall Street Snarls at S.E.C. Proposal on Disclosure*, THE NEW YORK TIMES, Dec. 16, 1999, at C1, available in 1999 WL 31760050.
  17. Gretchen Morgenson, *Less Than Full Disclosure*, THE NEW YORK TIMES, Oct. 31, 1999, at C1, available in 1999 WL 31765856.
  18. Norris, *supra* note 17, at C1.
  19. Final Release at 51,717 (arguing that “analysts predominantly issue ‘buy’ recommendations on covered issuers”).

comments,<sup>20</sup> the S.E.C., by a vote of 3 – 1, adopted Regulation FD on August 10, 2000.<sup>21</sup>

To be sure, the “feel good” Regulation FD comes at a time when insider trading appears to be once again hiding its ugly head, and phrased as a cure for corporate favoritism among investors, it seems very hard to oppose.<sup>22</sup> But, as a hybrid of rulemaking and adoption of existing caselaw that avoids defining key terms and sets up strict, new, corporate obligations, has it simply created fear, confusion, and even worse, yet more 10b–5 caselaw? Moreover, does it hearken a return to the era when the analyst was held by the S.E.C. to what was tantamount to a strict liability standard simply for being too much “in the loop” of corporate communications?

Part I of this article summarizes Regulation FD. Part II summarizes the “traditional” treatment accorded analysts by the S.E.C., private 10b–5 plaintiffs, and the courts, and describes two efforts in the 1990s by the Supreme Court and the Congress to remove analysts and similar ancillary players from the ever-burgeoning 10b–5 caseload. Part III provides a background for an evaluation of the analyst’s role by discussing his duties in corporate disclosure settings and the accolades consistently received therefor. Part IV discusses the possible flaws in Regulation FD while encouraging the S.E.C. to complete the more arduous, but surely more direct, approach of defining *materiality*.

## I. REGULATION FD

### A. Background

In the Proposal, the S.E.C. acknowledged that the media attention given to selective disclosure had turned its head, stating that:

Many recent cases of selective disclosure have been reported in the media. In some cases, selective disclosures have been made in conference calls or meetings that are open only to analysts and/or institutional investors, and

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20. Aaron Luchetti & Christopher Oster, *Janus Worries That S.E.C. Plan Will Limit Access*, THE WALL STREET JOURNAL, Aug. 9, 2000, at C1, available in 2000 WL-WSJ 3039511.

21. In a rare, non-unanimous vote, Commissioner Laura Unger voted against adoption of the regulation, stating that she feared it “casts too wide a net.” Danny Hakim, *S.E.C. Approves Regulation Against Selective Disclosure; Small Investors to Benefit, Chairman Says*, THE NEW YORK TIMES, Aug. 11, 2000, at C7.

22. It was the famous Dean and Professor Henry G. Manne who wrote, “After all, who can be against full disclosure? The very suggestion smacks of condoning fraud, lying and deceit.” Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 569 (1970).

exclude other investors, members of the public, and the media. . . . Commonly, these situations involve advance notice of the issuer's upcoming quarterly earnings or sales figures—figures which, when announced, have a predictable and significant impact on the market price of the issuer's securities.<sup>23</sup>

Thus, heeding the persistent call of critics,<sup>24</sup> the S.E.C. unequivocally targeted selective disclosure, stating that the common practice posed “a serious threat to investor confidence in the fairness and integrity of the securities markets.”<sup>25</sup> The Proposal also relied on a 1998 study by the National Investor Relations Institute, which disclosed that 26 % of responding companies “stated that they engage in some type of selective disclosure practices.”<sup>26</sup> Indeed, the Proposal noted that despite applicable rules of self-regulatory organizations (i.e., the NYSE, the NASD) that require prompt disclosure of material developments by listed companies, “issuers retain some control over the precise timing of many important corporate disclosures” as well as over the “audience and forum for some important disclosures.”<sup>27</sup> The rule sought to effectively outlaw an industry practice that, while traditional, had at times drawn harsh criticism from commentators advocating a theoretical “level playing field” of informational parity for all investors.<sup>28</sup>

The Final Release, too, relied heavily on a study by the National Investor Relations Institute study, this time for the argument that studies on improved corporate disclosure are not conclusive.<sup>29</sup> Making some modifications but staying true to the spirit of the Proposal, the Commission doubled the length of Regulation FD but refused to significantly tone down its breadth or tenor.<sup>30</sup>

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23. Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,591–92 (1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, and 249) (proposed Dec. 20, 1999).

24. See, e.g., John C. Coffee, Jr., *Is Selective Disclosure Now Lawful?*, 218 N.Y.L.J. 5 (1997).

25. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,592.

26. *Id.* at 72,591–92 n.11.

27. *Id.* at 72,591.

28. Coffee, *supra* note 24, at 5.

29. The study concluded that “most” issuers were already opening their conference calls to analysts, thus lessening the need for Regulation FD. Final Release at 51,717–18 (citing NIRI Executive Alert, *Most Corporate Conference Calls Are Now Open to Individual Investors and the Media*, Feb. 29, 2000).

30. The seven modifications incorporated into the final version of Regulation FD were: (1) the removal of foreign issuers from its application; (2) narrowing its scope from “all communications” to those communications made to four enumerated groups; (3) narrowing the issuer personnel covered by the regulation to “senior officials” and those persons who regularly communicate with securities professionals or shareholders; (4) expressly providing that the regulation does not create duties under Rule 10b–5; (5) providing that an issuer’s violation does not preclude the issuer from utilizing short form registration or security holders from reselling under Rule 144; (6) excluding communications made in connection with registered securities offerings; and (7) clarifying that violations require

Most notably, the Commission sought to narrow the scope of Regulation FD while alleviating fears of spurring class actions against issuers.

## B. What It Requires

Regulation FD, a self-coined “new issuer disclosure rule,”<sup>31</sup> does not mandate that issuers disclose all material developments, requiring instead “that when an issuer chooses to disclose material nonpublic information, it must do so broadly to the investing public, not selectively to a favored few.”<sup>32</sup> Rule 100 of Regulation FD<sup>33</sup> sets out the basics. Whenever an issuer or any person acting on its behalf, discloses material nonpublic information to any of the four enumerated groups of individuals, the issuer must “simultaneously” (for intentional disclosures) or “promptly” (for non-intentional disclosures) make public disclosure of that same information.<sup>34</sup> For intentional disclosures, “simultaneously” is not defined. For non-intentional disclosures, “promptly” is defined to mean “as soon as reasonably practicable” but in no case longer than twenty-four hours.<sup>35</sup>

Once triggered, the issuer’s “public disclosure” requirement can be met by several means. The Proposal had stated that the preferred manner of complying with public disclosure would be the filing of a Form 8-K with the Commission.<sup>36</sup> The Final Release loosened the requirement to include the filing<sup>37</sup> of a Form 8-K or alternative measures that could include the dissemination of a press release in conjunction with the holding of a public press conference (with notice), or any method/combination of methods “reasonably calculated to make effective, broad and non-exclusionary public

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knowing (or recklessly not knowing) that disclosed information is both *material* and *nonpublic*.  
*Id.* at 51,718–19 (emphasis added).

31. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,591. Regulation FD is actually a collection of four rules, numbered consecutively from 100 through 103.

32. *Id.* at 72,594.

33. The complete text of proposed Regulation FD is attached as Appendix 1.

34. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,594.

35. *Id.* at 72,596. An additional late modification by the Commission grants the non-intentionally disclosing issuer until the later of 24 hours or the next trading day’s opening on the NYSE. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,715, 51,722–23 (2000) (to be codified at 17 C.F.R. pts. 240, 243, and 249).

36. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,596.

37. Further, issuers are granted the option of “furnishing” a Form 8-K (i.e., including a report under the form’s Item 9) or “filing” a Form 8-K (i.e., completing a report under Item 5). Final Release at 51,723.

disclosure, given the particular circumstances” of the issuer.<sup>38</sup> Expressly not satisfactory is simply posting information on a website, absent other actions.<sup>39</sup>

### C. Whom It Applies To

Regulation FD would apply to virtually all reporting companies.<sup>40</sup> It prohibits selective disclosures made by a “person acting on behalf of an issuer” (e.g., “any senior official of the issuer” or “any other officer, employee, or agent of an issuer who regularly communicates” with industry professionals)<sup>41</sup> to any of four enumerated classes.<sup>42</sup> Those four classes are essentially “securities market professionals” (i.e., broker-dealers, investment companies, and investment advisors) and shareholders “under circumstances in which it is reasonably foreseeable that such person would purchase or sell securities on the basis of the information.”<sup>43</sup> At the behest of Commentators from the media, “ordinary-course business communications” (i.e., routine discussions with the press) were effectively exempted in the final version through the addition of the more specific provisions governing covered issuer personnel and information recipients.<sup>44</sup>

“Senior official” is defined as “any director, executive, officer, investor relations or public relations officer, or other person with similar functions.”<sup>45</sup> Disclosures made at the direction of a senior official are imputed to that official, but a person who communicates material, nonpublic information in breach of a duty to the issuer “would not be considered to be acting on behalf of the issuer.”<sup>46</sup>

Beyond the fabled closed-door meeting between management and analysts, Regulation FD would apply to a variety of situations in which selective disclosure may take place. Examples given are conference calls with

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38. *Id.* at 51,724.

39. *Id.*

40. *Id.* at 51,723–24. The Proposal estimated that each of the approximately 14,000 domestic issuers currently subject to reporting requirements submits, on average, two Forms 8–K to the Commission each year, at a production cost of approximately \$475 per filing. The Proposal further estimated that the total number of Form 8K filings would increase to approximately 70,000 per year as issuers complied with Regulation FD. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,606. The Final Release reiterated the S.E.C.’s support for its estimate of five additional Forms 8–K per year, per issuer under Regulation FD. Final Release at 51,731–32.

41. *Id.* at 51,739.

42. *Id.* 51,719.

43. *Id.* (citing 17 C.F.R. § 243.100(b)(1) (1999)) (“Rule 100(b)(1)”).

44. *Id.* at 51,720 (referencing Rule 100(b)(1)).

45. *Id.* at 51,720 n.34 (referencing 17 C.F.R. § 243.101(f) (1999)) (“Rule 101(f)”).

46. *Id.* at 51,720.



investors or analysts<sup>47</sup> and situations where any “material information” is communicated, verbally or in writing.<sup>48</sup> The regulation expressly does not apply to an issuer in registration, but it does apply to any private placement where there is no confidentiality agreement in place<sup>49</sup>. Three other exclusions remove from coverage disclosures to “temporary insiders” (e.g., an issuer’s attorney or an accountant), any person who expressly agrees to maintain the disclosed information in confidence, and entities whose primary business is the issuance of credit ratings (as long as the ratings are publicly available).<sup>50</sup> Stating that the Commission was “mindful” of Regulation FD’s “chilling” effect upon disclosure, the S.E.C. pointed out that any violations based upon intentional disclosures would require *scienter* or at least *recklessness* as a mental state in order to invite disciplinary action.<sup>51</sup> Likewise, the Commission added that the regulation “would not provide a basis for private liability.”<sup>52</sup>

#### D. Generally

Although aimed at what is described as a current practice, in many ways Regulation FD represents a summary of, and governmental reaction to, anti-fraud actions in the past. To that end, the Proposal traced some of the history leading up to the present state of 10b–5 prosecutions of selective disclosure of material information and also discussed some of the treatment that financial analysts have historically received under 10b–5 in the past.<sup>53</sup> As for the era in which people like Raymond Dirks and the unfortunate analysts in *Bausch and Lomb*<sup>54</sup> were seemingly charged for possessing inside information while making recommendations, the Proposal made short shrift of the S.E.C.’s earlier aggressive stance, concluding that “[a]fter *Dirks*, there have been very

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47. Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,591–92 (1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, and 249) (proposed Dec. 20, 1999).

48. *Id.* at 72,599.

49. Final Release at 51,719–20.

50. Selective Disclosure and Insider Trading at 72,720.

51. Final Release at 51,718. While *recklessness* as a mental state for a Rule 10b–5 violation has not been addressed by the Supreme Court, the majority of the circuit courts have held that *recklessness* is sufficient to state a claim. *See, In re Wells Fargo Secs. Litig.*, 12 F.3d 922 (9th Cir. 1993); *Breard v. Sachnoff & Weaver, Ltd.*, 941 F.2d 142 (2d Cir. 1991); and *Backman v. Polaroid Corp.*, 893 F.2d 1405 (1st Cir. 1990).

52. *Id.*

53. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,593–94.

54. *See infra* pp. 13–14.

few insider trading cases based on disclosure to, or trading by, securities analysts.”<sup>55</sup>

Despite being “designed to promote the full and fair disclosure of information by issuers”<sup>56</sup> and avowing its opposition to the selective disclosure of material, nonpublic information, both the Proposal and the Final Release lacked specifics on the contours of such information. Indeed, neither Regulation FD nor the Proposal’s accompanying comments and explanation (“Comments”) nor the Final Release define *material* or *nonpublic*. Instead, the Comments adopt the time-honored standard for “materiality” set forth in *TSC Indus. v. Northway, Inc.*<sup>57</sup> The Final Release reiterated the Commission’s support for *TSC Industries* while offering as examples, a handful of events likely to be deemed material (e.g., mergers, bankruptcies, and a change in auditors).<sup>58</sup>

Similarly, as guidance for discerning what is *nonpublic*, the Comments offered a citation to the flexible standard set by caselaw,<sup>59</sup> which requires “recognized channels of distribution” and offers public investors “a reasonable waiting period to react to the information.”<sup>60</sup> The Final Release, while suggesting a model combination of various methods by which news could be made public,<sup>61</sup> does not otherwise define *nonpublic*.

On several key points, the Proposal and the Final Release defer to civil cases brought by private plaintiffs.<sup>62</sup> As to the toughest question posed by selective disclosure (i.e., what is the content of an improper disclosure?), the S.E.C. stated the following:

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55. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,593. The Proposal also admits: “Under early insider trading case law, which appeared to require that traders have equal access to corporate information, selective disclosure of material information to securities analysts could lead to liability. This changed with the Supreme Court’s decisions in *Chiarella v. United States* and *Dirks v. S.E.C.*” *Id.*

56. *Id.* at 72,590.

57. *Id.* at 72,594. Specifically, a fact is material if “there is a substantial likelihood” that a reasonable investor “would consider it important,” or stated otherwise, if it would alter the “total mix of information” available to the investor. *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

58. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,715, 51,721 (2000) (to be codified at 17 C.F.R. pts. 240, 243, and 249).

59. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,595. See, *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968); *In the Matter of Investors Management Co.*, Release No. 34–9267, 44 S.E.C. 633 (July 29, 1971).

60. *In the Matter of Certain Trading in the Common Stock of Faberge, Inc.*, Release No. 34–10174, 45 S.E.C. 249, 255 (May 25, 1973).

61. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,724. For example, an issuer could (1) issue a press release; (2) provide notice of an accompanying conference call; and (3) make said conference call accessible by telephone or the Internet.

62. See, e.g., Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,594 n.36.

Although materiality issues do not lend themselves to a bright-line test, we believe that the majority of cases are reasonably clear. At one end of the spectrum, we believe issuers should avoid giving guidance or express warnings to analysts or selected investors about important upcoming earnings or sales figures; such earnings or sales figures will frequently have a significant impact on the issuer's stock price. At the other end of the spectrum, more generalized background information is less likely to be material.<sup>63</sup>

Likewise, the Final Release refers the reader to the Supreme Court's ruling in *Basic, Inc. v. Levinson*<sup>64</sup> for an elaboration on the flexible materiality standard invoked by Regulation FD.<sup>65</sup>

In sum, the S.E.C., in broad strokes, proposed to allow issuers and others a means of avoiding enforcement action (and perhaps, civil liability) by quickly reporting to all what was said to the few. Regulation FD establishes an amnesty, if you will, earned through an immediate rectifying of the situation. The S.E.C. fielded objections to the scope of and vagaries in Regulation FD until the end of April, and then announced in early August that the proposal would be brought to a vote on August 10<sup>th</sup>. The press was quick to focus on the public's widespread support for, and benefits from, the regulation.<sup>66</sup>

As for analysts, there is no similar benefit nor consideration. The Proposal, Comments, and Final Release contain no guidelines for analysts who find themselves in receipt of selectively disclosed information but do include plenty of warnings about 10b-5 liability:

Rule 102 [of Regulation FD] is designed to exclude Rule 10b-5 liability for cases that would be based "solely" on a failure to make a public disclosure required by Regulation FD. As such, it does not affect any existing grounds for liability under Rule 10b-5. Thus, for example, liability for "tipping" and insider trading under Rule 10b-5 may still exist if a selective disclosure is made in circumstances that meet the *Dirks* "personal benefit" test.<sup>67</sup> In addition, an issuer's failure to make a public disclosure still may give rise to liability under a "duty to correct" or "duty to update" theory in certain circumstances. And an issuer's contacts with analysts may lead to liability under the "entanglement" or "adoption" theories. In addition, if an issuer's report or public disclosure made under Regulation FD contained false or

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63. *Id.* at 72,595.

64. 485 U.S. 224 (1988).

65. Final Release at 51,721 n.38.

66. Hakim, *supra* note 21, at C7.

67. See *infra* pp. 14-16.

misleading information, or omitted material information, Rule 102 would not provide protection from Rule 10b-5 liability. Finally, if an issuer failed to comply with Regulation FD, it would be subject to an SEC enforcement action alleging violations of Section 13(a) or 15(d) of the Exchange Act (or, in the case of a closed-end investment company, Section 30 of the Investment Company Act) and Regulation FD. We could bring an administrative action seeking a cease-and-desist order, or a civil action seeking an injunction and/or civil money penalties. In appropriate cases, we could also bring an enforcement action against an individual at the issuer responsible for the violation, either as “a cause of” the violation in a cease-and-desist proceeding, or as an aider and abetter of the violation in an injunctive action.<sup>68</sup>

Despite this litany of disciplinary possibilities flowing from the new regulation, the S.E.C. seeks elsewhere in the Final Release to clarify that Regulation FD is not “an antifraud rule.”<sup>69</sup> Additionally, the Final Release specifically warns that “[i]f the issuer official communicates selectively to the analyst nonpublic information that the company’s anticipated earnings will be higher than, lower than, or even the same as what analysts have been forecasting, the issuer will have likely violated Regulation FD.”<sup>70</sup> Alarming, in concomitantly enacting Rule 10b5-1,<sup>71</sup> the Final Release also established liability for trading “while ‘aware’ of material nonpublic information,”<sup>72</sup> a standard that sounds a lot like the “parity of information” theory<sup>73</sup> from the 1970s. In that decade, until checked by the courts, the S.E.C. often lumped all violators and their assistants together, and, depending on the case, the courts either agreed, disagreed, or put up new “STOP” signs. As is manifestly clear, the S.E.C. was less than forgiving towards analysts who had failed to divine the Commission’s own signs.

## II. THE 1970s: NO FREE LOVE FROM THE S.E.C.

Throughout the 1970s, the S.E.C. actively pursued analysts it felt had used the “fencing match”<sup>74</sup> of corporate communications to their personal

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68. Final Release at 51,726.

69. *Id.*

70. *Id.* at 51,721.

71. Rule 10b5-1, in relevant part, is included as Appendix 2.

72. Final Release at 51,727-29 (emphasis added).

73. Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,593 (1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, and 249) (proposed Dec. 20, 1999).

74. S.E.C. v. Bausch & Lomb, Inc., 565 F.2d 8, 9 (2d Cir. 1977).

advantage. Arguably, the "total mix" standard of *TSC Industries*<sup>75</sup> was often deemed subordinate by the Commission to considerations of the exclusivity of the source information. For example, amidst incontrovertible evidence of prolonged falling stock prices, an analyst was charged for recommending the sale of the remainder of his firm's inventory when it seemed that such action was motivated by private disclosures from company management.<sup>76</sup>

Overall, analysts were fair game for S.E.C. actions, often prosecuted under doctrines resembling or outright constituting the "parity of information" theory.<sup>77</sup> In one broad case, no less than fifteen different investment advisers were charged with violating 10b-5 for recommending and/or effecting sales of stock in Douglas Aircraft Co., Inc. after discussions with company management or its underwriters disclosed anticipated reports of lower earnings.<sup>78</sup> Twelve of these parties were censured.<sup>79</sup> On appeal, the S.E.C. upheld the censures, summarily reasoning the trading to be violative because the information underlying it was not generally known:

We consider that one who obtains possession of material, non-public corporate information, which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information, within the purview and restraints of the antifraud provision [of the Securities Acts].<sup>80</sup>

But while the S.E.C.'s pursuit of this case, *Investors Management Co., Inc.*, may frighten an analyst, its actions in *Bausch & Lomb* should send him scurrying under the bed. In that case, the S.E.C. charged issuer and analyst alike for negative trading recommendations that transpired during a well-documented "bear market" in the lens maker's stock due to documented

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75. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

76. *See, e.g., S.E.C. v. Lum's Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973) (analyst/stockbroker charged with recommending that his institution sell its remaining block of 83,000 shares within approximately one month of liquidating 42,000 shares of the same stock). The court acknowledged that there was "apparently general knowledge" of the relevant industry's "riskiness" and "growing difficulties" at the time of the second sale. *Id.* at 1059 n.1. The court also took the occasion to note the traditional, strict definition of an "illegal tip," (i.e., *S.E.C. v. Texas Gulf Sulphur* had focused on the simple comment to a tippee that a company was "a good buy"). *Id.* at 1059.

77. *Selective Disclosure and Insider Trading*, 64 Fed. Reg. at 72,593.

78. *In the Matter of Investors Management Co., Inc.*, Admin. Proc. File No. 3-1680, 1970 S.E.C. LEXIS 3042 (June 26, 1970) ("Investors Management").

79. *Id.* at \*129.

80. *In the Matter of Investors Mgmt. Co., Inc.*, Admin. Proc. File No. 3-1680, 1971 S.E.C. LEXIS 962, at \*24 (July 29, 1971).

factors including, among other things, pressure from rivals, a delay in product shipments, and growing questions about the safety of soft lenses.<sup>81</sup>

#### A. The *Bausch & Lomb* Nightmare

The S.E.C. alleged illegal “tipping” during a series of March, 1972 meetings between the CEO and analysts who covered Bausch & Lomb, Inc. at a time when the company’s fortunes were changing after a period of growth occasioned by its breakthrough in the area of soft contact lenses.<sup>82</sup> The S.E.C.’s program ran aground, however, as a district court judge from the Southern District of New York denied the S.E.C.’s application for a permanent injunction seeking to prohibit Bausch & Lomb, Inc. and its CEO from further violations of 10b–5.<sup>83</sup> Noting that the CEO did not trade for his own benefit, the district court held that there was a lack of *scienter*, and further reminded that:

The permissible scope of corporate communication with security analysts has yet to be authoritatively defined. As noted by this Court at the conclusion of trial, injunctions as extraordinary remedies, should be issued when they are needed in extraordinary situations and should not be utilized generally in lieu of administrative regulations.<sup>84</sup>

On appeal, the Second Circuit agreed with the district court’s denial of the injunction,<sup>85</sup> noting, *inter alia*, that it did not accept the S.E.C.’s “facile inference” that all evidence imparted by the CEO must have been *material* because the stock dropped over eleven points the day after one of the March meetings.<sup>86</sup> The court placed the S.E.C.’s accusations in the context of a forty-point stock drop in the three weeks before the meetings and reiterated the district court’s findings that the CEO was “a sincere and honest man, who, out of an excessive zeal for fairness and accuracy . . . allowed material inside information to ‘pop out.’”<sup>87</sup> Noteworthy is the fact that, before the S.E.C.’s allegations were shot down by the courts, two of the analysts charged for recommending to their firm the liquidation of its Bausch & Lomb position after these March meetings consented to judgments enjoining them from

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81. S.E.C. v. Bausch & Lomb, Inc., 420 F. Supp. 1226 (S.D.N.Y. 1976).

82. *Id.* at 1234–38.

83. *Id.* at 1246.

84. *Id.* at 1245.

85. S.E.C. v. Bausch & Lomb, Inc., 565 F.2d 8 (2d Cir. 1977).

86. *Id.* at 15.

87. *Id.* at 18–19.

future violations of federal antifraud provisions.<sup>88</sup> Thus, ironically, the inequitable result followed that analysts were disciplined even though their "tippers" were not. However, a subsequent Supreme Court holding<sup>89</sup> brought more attention to the weaknesses in the S.E.C.'s 10b-5 theories.

## B. The *Dirks* Correction

The story of Raymond Dirks is by now legendary within 10b-5 caselaw. The facts transpired during roughly a three week period in March 1973.<sup>90</sup> After Ronald Secrist ("Secrist"), a former employee of the publicly-traded Equity Funding Corporation of America ("Equity"), alerted Dirks to possible massive fraud at the insurance company, Dirks attempted to get *The Wall Street Journal* to publish an article.<sup>91</sup> He also conducted his own investigation by interviewing present and former Equity employees.<sup>92</sup> During this process, Dirks spoke with analysts and others about his meeting with Secrist and, at various times, advised his clients to sell their Equity holdings.<sup>93</sup> Ultimately, Dirks was interviewed by the S.E.C. and told them what he knew about the alleged scandal.<sup>94</sup> The S.E.C.'s Division of Enforcement charged Dirks with aiding and abetting 10b-5 violations by passing Secrist's "tip" onto his clients.<sup>95</sup> Five investment analysts contacted by Dirks during these events were also charged by the S.E.C. and received the penalty of censure.<sup>96</sup>

An administrative law judge found Dirks guilty and suspended him for sixty days.<sup>97</sup> On appeal, the Commission noted that, despite their "utility," analysts "have no special license to ignore the insider trading proscriptions of the federal securities laws."<sup>98</sup> Admitting that there exists a "generally permissible" research advantage, Commissioners nonetheless concluded that:

[B]ecause of the nature of their activities, analysts must be alert to the line between proper—even laudatory—analytical efforts and unlawful tipping.

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88. S.E.C. v. Bausch & Lomb, Inc., Release No. 6979, 1975 S.E.C. LEXIS 1227, at \*1 (S.D.N.Y. July 11, 1975) (notice of consent to issuance of final injunction).

89. *Dirks v. S.E.C.*, 463 U.S. 646 (1983).

90. *Id.*

91. *Id.* at 649.

92. *Id.*

93. *Id.*

94. *Id.* at 670.

95. In the Matter of Raymond L. Dirks, Exchange Release No. 17480, 1981 S.E.C. LEXIS 2213, at \*1 (June 22, 1981) (citing to the initial S.E.C. proceeding below).

96. *Id.* at \*35.

97. *Id.* at \*2.

98. *Id.* at \*18.

Where 'tippees'—regardless of their motivation or occupation—come into possession of material 'corporate information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading.<sup>99</sup>

Eventually, the Supreme Court reversed, holding that Dirks owed no duty to Equity shareholders, either directly or derivatively.<sup>100</sup> The Court clarified that a duty to disclose does not arise simply "from one's ability to acquire information because of his position in the market."<sup>101</sup> Dirks, therefore, could not be guilty as a primary violator under 10b-5.<sup>102</sup> To the same end, Dirks, as the "tippee," had no duty to disclose or abstain from use of the inside information obtained derivatively from the corporate insider (Secrist) because Secrist, having gained no benefit from his "tip," could not be a "tipper."<sup>103</sup>

Thus, the Supreme Court expressly considered and rejected the notion that the mere possession of material nonpublic information, absent a duty to shareholders, could create the obligation to disclose or abstain.<sup>104</sup> It was this halting by the Supreme Court of the S.E.C.'s liberal application of the "parity of information" theory<sup>105</sup> that perhaps most contributed to the development of the "misappropriation theory" under 10b-5,<sup>106</sup> which focuses on a deceptive manner of obtaining nonpublic information instead of any uniqueness of position.

On another occasion in the 1970s, the S.E.C. sought to impose upon analysts a duty to verify whether information obtained was public; however, this theory was rejected by the court in *S.E.C. v. Monarch Fund*.<sup>107</sup> In that case, the Second Circuit summarily concluded that carrying such a theory "to its logical conclusion" would mean that all investment advisers "who are attracted to a particular security . . . and seek to obtain further information about it act at their peril."<sup>108</sup>

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99. *Id.* at \*19 (citing *Chiarella v. United States*, 445 U.S. 222, 230 n.12 (1980)). However, the Commission reduced Dirks' sanction from a suspension to a censure, noting his assistance in the subsequent investigation of Equity and his previously unblemished tenure in the securities industry. *Id.* at \*35.

100. *Dirks v. S.E.C.*, 463 U.S. 646, 667 (1983).

101. *Id.* at 658 (citing *Chiarella v. United States*, 445 U.S. 222 (1980)).

102. *Id.* at 665.

103. *Id.* at 659-61, 667.

104. *Id.* at 653-54.

105. *See*, Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,593 (1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, and 249) (proposed Dec. 20, 1999).

106. *See id.* at 72,602.

107. *S.E.C. v. Monarch Fund*, 608 F.2d 938 (2d Cir. 1979).

108. *Id.* at 943.



Against this very aggressive and somewhat indefensible past, the S.E.C. sought, through the Proposal, to make amends for its prior treatment of analysts and promise a more temperate future. But, notably, the Commission did not wed itself to guidelines for dealing with advisers or analysts who obtain questionable information. Commentators would agree that, post-*Dirks*, the S.E.C. has demonstrably cooled its jets in terms of charging analysts. But no Supreme Court holding or other limitation precludes the Commission from charging analysts with, among other things, "aiding and abetting" 10b-5 violations. Further, Regulation FD inevitably invites private litigation and, as that remedy has grown exponentially, analysts have remained a favorite target of plaintiffs' attorneys. In this particular sea of litigation, neither actions by the Supreme Court nor Congress have helped to stem the tide.

### C. The Actions To Limit Private Actions In The 1990s

Despite the Supreme Court limiting the application of 10b-5 by rejecting the "parity of information" theory<sup>109</sup> espoused by *Dirks*, there were enough theories around to allow for abounding private actions under the rule in the 1980s and 1990s. Consequently, by the middle of the last decade, there was open concern at the S.E.C. and in Congress that abusive litigation was chilling disclosure by corporate management.<sup>110</sup> Again, the tightrope analogy fits, as analysts were dragged into the fray when their projections (based upon company figures) missed the mark, or they could simply be linked to insiders alleged to have profited from corporate misfortunes.<sup>111</sup>

Both the Congress and the federal bench took note that the securities laws were being invoked frivolously. By mid-decade, there was hope that a 1994 Supreme Court ruling would eradicate aiding and abetting liability, thus saving many types of professionals from being included in 10b-5 suits; alas,

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109. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,593.

110. See, testimony of Hon. Richard C. Breeden, former Chairman, S.E.C., before the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs (Apr. 6, 1995), available at 1995 WL 155054 ("Shareholders are also damaged due to the chilling effect of the current system on the robust and candor of disclosure . . . . Understanding a company's own assessment of its future potential would be among the most valuable information shareholders and potential investors could have about a firm.").

111. See, e.g., *In re Caere Corp. Sec. Litig.*, 837 F. Supp. 1054 (N.D. Cal. 1993); *In re Cirrus Logic Sec. Litig.*, 946 F. Supp. 1446 (N.D. Cal. 1996). See generally, *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 163 (2d Cir. 1980) (establishing the "entanglement theory" for evaluating relationships and apportioning culpability between issuers and analysts).

in hindsight, a broad allegation of “conspiracy” involving these individuals often survives.<sup>112</sup>

Specifically, in *Central Bank, N.A. v. First Interstate Bank, N.A.*,<sup>113</sup> it was expressly held by the Supreme Court that there could be no civil liability for damages for aiding and abetting a violation of Rule 10b-5.<sup>114</sup> The Court’s decision unequivocally concluded that “the text of the 1934 Act does not itself reach those who aid and abet a §10(b) violation.”<sup>115</sup> However, while the decision had an immediate and salubrious effect on the trustee bank that had been joined in what was essentially a case of bad municipal bonds, it has actually only posed minor obstacles for plaintiffs’ attorneys drafting future complaints against analysts.

After *Central Bank*, there are still suits in which secondary actors are named, just in different terms. The label “abettor” has been seamlessly replaced by “conspirator,” and the courts have even expressly stated that the plaintiff was not limited by *Central Bank*.<sup>116</sup> In *Cooper v. Pickett*, two analysts employed by firms underwriting the proposed stock offering by a computer company were named as defendants in the plaintiff’s class action alleging a conspiracy to keep adverse corporate information from the public.<sup>117</sup> The suit specifically alleged violations of Sections 10b and 20(a) of the Exchange Act.<sup>118</sup> The complaint alleged that the defendants “falsely presented the Company’s current and future business prospects and prolonged the illusion of revenue and earnings growth” through communications with securities analysts who then repeated these representations in favorable research reports.<sup>119</sup> Indeed, the complaint focused on conference calls between management and the two analyst defendants.<sup>120</sup> A district court had

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112. See, e.g., *Cooper v. Pickett*, 137 F.3d 616, 625 (9th Cir. 1997) wherein both Merisel, Inc. company officials and analysts with whom they communicated were sued (“Plaintiffs’ claims therefore are not barred by *Central Bank* in that they are asserting that Merisel, through false statements to analysts, and those analysts, by issuing reports based on statements they knew were false, together engaged in a scheme to defraud the shareholders.”). See also, *Genna v. Digital Link Corp.*, 25 F. Supp. 2d 1032, 1042 (N.D. Cal. 1997) (“The court is not persuaded that a ‘scheme to defraud’ could not be alleged which would be outside the scope of the ‘aiding and abetting’ activity discussed in *Central Bank*.”).

113. *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994).

114. *Id.* at 191.

115. *Id.* at 177.

116. See, e.g., *Cooper v. Pickett*, 137 F.3d 616.

117. *Id.* at 619–20.

118. *Id.* at 619. Section 20(a) of the Exchange Act imposes joint and several liability upon parties found to have controlled persons who violate any provision of the act. 15 U.S.C. § 78t(a) (1994).

119. *Id.* at 620.

120. *Id.* at 623.

dismissed the complaint as to all defendants<sup>121</sup> but, on appeal, the 9<sup>th</sup> Circuit reinstated the claims and rejected all of the defendants' arguments, including the defense that aiding and abetting liability had been eradicated by *Central Bank*.<sup>122</sup>

Likewise, there was the hope that the Private Securities Litigation Reform Act of 1995 ("PSLRA"),<sup>123</sup> with its heightened pleading standard, would help to stem litigation against analysts, accountants, and other third parties. However, the PSLRA arguably acted only to provide a road map on how to successfully join analysts in a 10b-5 suit. Witness the court's words in *McNamara v. Bre-X Minerals, LTD.*<sup>124</sup> in dismissing the claims against the analysts *without prejudice*:

[T]he Plaintiffs failed to make the allegation regarding [the analyst's] knowledge of the test results with sufficient particularity. The Plaintiffs do not specify when and how [the analyst] learned of the test results. . . . The Plaintiffs also allege that [the firm] learned there was no gold . . . through a visit [the analyst] made. . . . The Plaintiffs must allege in more detail to what [the analyst] was made privy. What tests did [the analyst] observe Bre-X perform and how did those tests depart so far from accepted practices that [the analyst] knew or recklessly disregarded the fact that the entire project was a hoax? . . . How do the Plaintiffs know what [the analyst] saw and was made privy to . . . ?<sup>125</sup>

Thus, when it comes to limiting suits against professionals who are not primary violators, the courts and the Congress have arguably been of little help. Inevitably, the path that 10b-5 litigation follows, at least by default, is going to be chosen by the Commission, as the private bar immediately converts new duties into failed obligations. It seems odd, then, that the Proposal and the Final Release, while ostensibly encouraging disclosure, provide neither indication of the *analyst's* duties when confided in by management nor even protection from allegations of having been a party to improper disclosure. This total disregard by the Commission of the fate of the analyst is hardly commensurate with the flattering appraisals of analysts inked by the courts and the S.E.C. in the last thirty years.

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121. *Id.* at 621.

122. *Id.* at 624-25.

123. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

124. *McNamara v. Bre-X Minerals, LTD.*, 57 F. Supp. 2d 396 (E.D. Tex. 1999).

125. *Id.* at 420. Separately, the PSLRA also affirmed that, despite *Central Bank*, the S.E.C. retained the authority to prosecute aiding and abetting violations. *See*, § 104, 109 Stat. at 757.

### III. PLACING A VALUE ON ANALYSTS

Curiously, it is the cases *against* analysts that seem to most lavishly praise their worth. Thus, although pilloried at times for their alleged part in the distribution of inside information, analysts are consistently supported, in theory, by the S.E.C. and jurists alike. As the *Bausch & Lomb* court stated:

Analysts provide a needed service in culling and sifting available data, viewing it in light of their own knowledge of a particular industry and ultimately furnishing a distilled product in the form of reports. These analyses can then be used by both the ordinary investor and by the professional investment adviser as a basis for the decision to buy or sell a given stock. The data available to the analyst – his raw material – comes in part from published sources but must also come from communication with management. Both the NYSE and the SEC have encouraged publicly traded companies to maintain an “open door” policy toward securities analysts.<sup>126</sup>

Indeed, the duty of the analyst in selective disclosure situations might aptly be termed Herculean. Expected to create news but prohibited from revealing secrets, the analyst is truly trapped in an oxymoronic duty. Witness the daunting instruction in the landmark case of *Elkind v. Liggett & Myers, Inc.*, that the law permit a “skilled analyst with knowledge of a company and the industry [to] piece seemingly inconsequential data together with public information into a mosaic which reveals *material non-public* information.”<sup>127</sup> In the Final Release, the S.E.C. echoed this tribute to analysts’ vaulted (if not cryptic) task:

. . . 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 [sic] significance is discerned by the analyst.<sup>128</sup>

Legally, the analyst’s task began to approach the insurmountable when it was determined that she and the issuer need not personally make money from trading to have nonetheless served as “tippee” and “tipper,” respectively, in a 10b–5 chain of liability. This development was occasioned

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126. *S.E.C. v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1230 (S.D.N.Y. 1976).

127. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980) (emphasis added).

128. Final Release at 51,722.

by the oft-understated theoretical expansion of the "benefit" of an issuer's illegal "tip" through two federal cases. In *Dirks*, the Supreme Court, while holding that there must exist a personal gain to the "tipper" to establish a breach of fiduciary duty, held that such personal gain could even take the form of a "reputational benefit."<sup>129</sup> Subsequently, in *S.E.C. v. Gaspar*,<sup>130</sup> a district court expanded this liberal notion of personal gain to include "any reputational benefit," i.e., enhancing a professional relationship or even bestowing a "gift."<sup>131</sup> Indeed, it is now woven into the very fabric of 10b-5 caselaw that the "tipper" need not gain financially nor tangibly to be found to have caused a violation.<sup>132</sup> In the aftermath of these two cases, merely acting as an analyst consistently covering the same company would seem to supply the requisite "benefit" to a "tipper" at a company for purposes of 10b-5 claims. Thus, the analyst, as part of his everyday job, could unwittingly be fulfilling the dictates of the tipper-tippee equation.

### With Friends Like These . . .

Despite this rough treatment, the analyst is consistently hailed by the S.E.C. and others as a worthy check on a company's self interested disclosure.<sup>133</sup> As recently as May of this year, the Commission reminded issuers whose securities are in registration to "maintain communications with the public" including answering "unsolicited telephone inquiries concerning business matters from securities analysts."<sup>134</sup> Indeed, on one level, the disinterested analyst serves to corroborate the disclosure made by a company acting in good faith but fearing market suspicion. Wholly apart from these

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129. *Dirks v. S.E.C.*, 463 U.S. 646, 663 (1983).

130. *S.E.C. v. Gaspar*, No. 83 Civ. 3037, 1985 U.S. Dist. LEXIS 20698 (S.D.N.Y. Apr. 16, 1985) (defendant analyst/securities salesman privy to a client's acquisition negotiations held to have revealed confidential information to stock broker to enhance their "professional relationship" or alternatively, bestow a "gift"). *Id.* at \*42-45.

131. *Id.* at \*43-44.

132. *See, e.g., S.E.C. v. Mayhew*, 121 F.3d 44 (2d Cir. 1997) (tipping found in the context of Rule 14e-3 liability); *S.E.C. v. Warde*, 151 F.3d 42, 49 (2d Cir. 1998) ("The close friendship between [tipper] and [tippee] suggests that [tipper's] tip was 'intended to benefit' [tippee], and therefore allows a jury finding that [tipper's] tip breached a duty under § 10(b).").

133. *See, S.E.C. v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1230 (S.D.N.Y. 1976).

134. S.E.C. Interpretation, *Use of Electronic Media*, Release Nos. 33-7856, 34-42728 (Rel. Apr. 28, 2000) (to be codified at 17 C.F.R. pts. 231, 241, and 271), available at <<http://www.sec.gov/rules/concept/34-42788.htm>>.

“moral hazard” considerations raised by learned academics,<sup>135</sup> it is the analyst whose core function is to sift through puffery and root out the inconsequential.<sup>136</sup> Ironically, it was the S.E.C. itself that urged this view upon the courts, for it was the Commission that held, *In the Matter of Raymond L. Dirks*, that “[t]he value to the entire market of [analysts’] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst’s work redounds to the benefit of all investors.”<sup>137</sup>

These random and arguably insincere platitudes resound through the Proposal and the Final Release.<sup>138</sup> The S.E.C. reiterates that analysts serve a screening function for technical financial information, even acknowledging that “if it served an issuer’s corporate interests to make disclosure of material information to selected analysts . . . it could do so, provided that the recipients” expressly agree to keep such information confidential.<sup>139</sup> Additionally, the S.E.C. expressly avows that “benefits may flow to the

135. The “moral hazard” that issuers face and the utility of analysts in overcoming this hazard are well described in the writings of Professor Langevoort. See, Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1030 (1990) (stating that:

A third purpose served by informal contacts [with analysts], perhaps the most intriguing, is that they operate to overcome a serious moral hazard problem in the process of corporate disclosure. An issuer wishing to make public disclosure of positive information faces the natural suspicion of the investing public: many previous issuers have lied about or otherwise overstated their financial condition or future prospects. Because of this moral hazard a company telling the truth must seek ways of bonding the accuracy of the information.).

136. See, Symposium, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. S.E.C.*, 13 HOFSTRA L. REV. 127 (1984) (stating that:

Analysts serve a monitoring function as well as providing a conduit for the transmission of information. Because managers may disseminate false information about the firm, or may attempt to conceal negative information, analysts have incentives to engage in some search themselves before making recommendations to their clients. This monitoring activity is a natural complement to the role of analysts in communicating information about the firm to investors.).

137. *In the Matter of Raymond L. Dirks*, Release No. 17480, 1981 S.E.C. LEXIS 2213, at \*18 (Jan. 22, 1981).

138. See, e.g., *Selective Disclosure and Insider Trading*, 65 Fed. Reg. 51,716, 51,722 (2000) (to be codified at 17 C.F.R. pts. 240, 243, and 249) (“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.”).

139. *Selective Disclosure and Insider Trading*, 64 Fed. Reg. 72,590, 72,595 (1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, and 249) (proposed Dec. 20, 1999). The examples given by the S.E.C. for such selective disclosure are for the purpose of having analysts “analyze complex information before its public release, or to solicit analysts’ views on a business strategy under consideration.” *Id.* See also, Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 879 (1983) (“[T]he argument [concerning the delaying of disclosure of information] assumes that all information can be disclosed. But information such as revisions of probabilities of future states cannot necessarily be conveyed directly.”).

markets from the legitimate efforts of securities analysts" because of their "superior diligence and acumen."<sup>140</sup> The Proposal even heralded the regulatory role of analysts who review issuers' reports pre-publication by citing to *S.E.C. v. Stevens*,<sup>141</sup> a 1991 case in which the court specifically noted that an analyst who had covered the company in issue "ceased his coverage and publicly challenged" the financial figures released by the company's CEO.<sup>142</sup> Yet, the S.E.C. simultaneously undermines this champion, clearly stating, "Whereas issuers once may have had to rely on analysts to serve as information intermediaries, issuers can now use a variety of methods to communicate directly with the market."<sup>143</sup>

Thus, the S.E.C. seems to be speaking out of both sides of its mouth. Despite its continued celebration of analysts, the Proposal and the Final Release, in spirit and in letter, strike a harsh balance against their continued utility. Based upon a perception of widespread corporate favoritism that is questioned by, among others, at least one former Commissioner,<sup>144</sup> the analyst has been demoted to but one source of information for the New Economy's aggressively investing public. Such a demotion seems a high price to pay in light of the Regulation FD's weaknesses, namely its vagaries, omissions, and chilling threats.

#### IV. MISSING THE MARK?

To be sure, Regulation FD suffers from its undefined terms including "materiality," "nonpublic," and "broad, non-exclusionary" public disclosure.<sup>145</sup> For example, where does one draw the line between "recklessly intentional" and "non-intentional" disclosures of material information? In a larger sense, what is a non-intentional disclosure, and which unlucky issuer would like to be the first to find out? What is a "publicly available credit

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140. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,592.

141. *S.E.C. v. Stevens*, Release No. 12813, No. 91 Civ. 1869, 1991 S.E.C. LEXIS 451 (S.D.N.Y. Mar. 19, 1991). In that case, the CEO was charged with violations of § 17(a) of the Securities Act of 1933 ("1933 Act") and § 10b of the Exchange Act after placing a series of unsolicited telephone calls to several analysts in which he gave details about his company's quarterly earnings. These analysts then recommended that their clients sell the company's stock. The analysts to whom he so disclosed were not charged. *Id.* at \*2-3.

142. *Id.* at \*2.

143. Final Release at 51,717.

144. See, e.g., Norris, *supra* note 17, at C1 (comments of former S.E.C. Commissioner Edward H. Fleischman stating "I would question the assumption that there is widespread practice that gives rise to this stain [as coined by Chairman Levitt] . . . that it is widespread, that I doubt.").

145. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,594-95.

rating,” and why should the agency that prepares it be entitled to an exemption that a fund with an audience of sixteen million investors does not enjoy?<sup>146</sup> Does an announcement on CNBC’s popular “Conference Call” television program constitute “public disclosure”? Does any television program (cable or otherwise) by itself ensure broad disclosure as mandated by new Rule 101(e)? Indeed, there exist additional mixed signals on the means of public disclosure throughout the Proposal.<sup>147</sup> As in prior S.E.C. releases concerning adequacy of corporate communications in this technological era, the Commission’s message remains blurred, as both the Proposal and the Final Release promote the Commission’s own EDGAR disclosure system while at times decrying the use of an Internet website as a universal medium.<sup>148</sup>

Regarding the usefulness of analysts in general, S.E.C. support for analysts, like the Cheshire cat’s grin, conveniently appears and vanishes. From a marketplace standpoint, this is a dangerous time for the S.E.C.’s grin to disappear, for the choice has been made to loose raw corporate information upon an investing public that, for the most part, has never seen a bear market.<sup>149</sup>

146. See, e.g., David Henry, *Small Investors to Get Equal Access to Company Information*, USA TODAY, Aug. 10, 2000, at 3B, available in 2000 WL 5786372.

147. See, Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,595–97.

148. See *id.* at 72,593, 72,597. The Commission apparently cannot decide what weight is to be accorded a company’s website. The Proposal contradicts itself concerning the adequacy of mass communications, stating that “[d]espite the rapid expansion of Internet access, a significant number of households do not have access. Moreover, simply putting information on a website does not alert investors that it is available.” *Id.* at 72,597 n.51. The Proposal also states that “[w]e [the S.E.C.] also have greater flexibility and improved technology for widespread dissemination of information. The Commission’s EDGAR system permits investors to access issuer information [through the Internet] almost as soon as it is filed with us.” *Id.* at 72,593 n.24. But critics have been quick to note that it takes 24 hours for filings with the S.E.C. to appear on its website. See, Michael Schroeder & Randall Smith, *Disclosure Rule Cleared By the S.E.C.*, THE WALL STREET JOURNAL, Aug. 11, 2000, at C1, available in 2000 WL-WSJ 3039939. Finally, the Final Release acknowledges that those issuer’s “whose websites are widely followed” could utilize them in conjunction with other methods in attempting to effectuate legal, broad disclosure. Final Release at 51,724.

149. The S.E.C.’s smile upon analysts is apparently also dependent on the type of information to be entrusted to the public: In July of this year, the S.E.C. proposed Rule 11Ac1–5, which would require exchanges and other “market centers” to make available to the public monthly reports on execution quality. The S.E.C. has expressly enlisted the help of analysts in acting as an intermediary of this new, market information:

...the information will need to be summarized and analyzed before it is helpful to investors in general. The Commission anticipates that independent analysts, consultants, broker-dealers, the financial press, and other market centers will analyze this information and produce summaries that respond to the needs of investors.

S.E.C. Release, *Disclosure of Order Routing & Execution Practices*, No. 34–43084, Rel. July 28, 2000 (to be codified at 17 C.F.R. pt. 240), available at



The Proposal also treads on dangerous ground by unabashedly adopting plaintiffs' civil actions, which contains a series of heretofore unpredictable 10b-5 standards at best.<sup>150</sup> The frightening aspect of this adoption is the augur of yet *more* 10b-5 liabilities, for both the Proposal and the Final Release, by filling in the gaps of S.E.C. regulation with private caselaw, end up indirectly supporting its expansion and growth.

#### A. Setting Implied Actions To S.E.C. Music

The S.E.C. acknowledges that Regulation FD is designed to create duties under Section 13(a) of the Exchange Act.<sup>151</sup> To meet the "broad, non-exclusionary" requirement of *public disclosure*, the Final Release states that issuers can "furnish or file" (i.e., follow Item 5 or 9 of Form 8-K) while elsewhere, the Commission clarifies that the failure to make the newly imposed Section 13 filing cannot form the basis for a Rule 10b-5 violation (but can form the basis for a Section 13 violation).<sup>152</sup> An unsavory result of these provisions is that an issuer might decide it is in its interest to forgo filing and chance a Section 13 action rather than make an admission of having disclosed material nonpublic information that invites scrutiny as to, among other things, motive and the immediacy and thoroughness of redress. Stated otherwise, given the uncertainty surrounding the question of whether *material* information has been imparted, as well as the fact that courts are loath to imply private actions from Section 13,<sup>153</sup> an issuer might just risk the reporting violation rather than make a filing, which serves as an admission that is almost certain to invite 10b-5 class action claims.

Additionally, while affirming that failure to comply with Regulation FD may lead to an S.E.C. Enforcement action,<sup>154</sup> the Proposal distinguished that the regulation did not create an implied civil remedy, and strangely, that it did not create duties under Section 10(b) of the Exchange Act.<sup>155</sup> However, the S.E.C. certainly doth protest too much, for the Proposal concomitantly cited to the *Dirks* "personal benefit" test<sup>156</sup> as well as two other private litigations

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<<http://www.sec.gov/rules/proposed/34-43084.htm>>.

150. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,594 n.36.

151. *Id.* at 72,598.

152. Final Release at 51,723, 51,726.

153. *See, In re Penn Cent. Secs. Litig.*, 357 F.Supp. 869 (E.D. Pa. 1973), *aff'd* 494 F.2d 528 (3rd Cir. 1974).

154. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,598.

155. *Id.*

156. *Id.* (citing *S.E.C. v. Stevens*, Release No. 12813, No. 91 Civ. 1869, 1991 U.S. S.E.C. LEXIS 451 (S.D.N.Y. Mar. 19, 1991)).

addressing 10b-5 liability for inadequate disclosure.<sup>157</sup> Likewise, in the Final Release, the S.E.C. pointedly reminded issuers and others that selective disclosure to analysts is not shielded from insider trading liability.<sup>158</sup>

Moreover, elsewhere in the Final Release, the S.E.C. expressly repeated that it had precluded 10b-5 violations based upon a failure to *file* a Form 8K but offered no similar 10b-5 protection for Forms 8-K that *are* filed. Noteworthy is the fact that a filing under Regulation FD is an incontrovertible admission by the issuer that it improperly disclosed information. If, as the S.E.C. admits, the universally-dreaded “chilling effect” upon issuers is directly related to their perceptions concerning private litigation,<sup>159</sup> then the Commission’s promise of no civil liability has already been discarded, as issuers and their legal counsel have been quick to evidence a desire to simply choke off relations with analysts altogether.<sup>160</sup> Clearly, the private sector is not convinced that the S.E.C. has precluded class actions following Regulation FD filings or violations.<sup>161</sup>

Thus, we are concurrently being asked to accept that (1) the S.E.C. is not creating 10b-5 duties; (2) there will be 10b-5 enforcement action following a faulty compliance with the new Section 13 duties; and yet (3) the S.E.C. is not encouraging private enforcement of the new obligations through civil 10b-5 cases. In light of 10b-5 history, there is of course, plenty of evidence that such a blank check will be cashed by the Commission and private litigants

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157. *Id.* (citing *Backman v. Polaroid Corp.*, 910 F.2d 10 (1st Cir. 1990); *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980)). From the start, the S.E.C. has warned that any public disclosure made under Regulation FD that contained false or misleading information, or omitted information, could invoke enforcement action based upon § 10(b) or § 18 of the Exchange Act, while a flawed Form 8-K could trigger § 11 liability under the 1933 Act. *Id.*

158. Final Release at 51,716 n.7.

159. *See id.* at 51,726.

160. Within a week of the adoption of Regulation FD, the California law firm that serves as counsel to Cisco Systems, Inc. and E\* Trade Group, Inc. stated that it planned to advise clients “that if it isn’t too detrimental to relations with analysts and others, forgoing such conversations is the safest thing to do.” Jeff D. Opdyke & Aaron Luchetti, *Mum’s the Word in Wake of Disclosure Rule*, THE WALL STREET JOURNAL, Aug. 16, 2000 at C1, available in 2000 WL-WSJ 3040340. Similarly, Atlanta’s 475-lawyer firm of Alston & Bird L.L.P. has already warned clients that Regulation FD “makes it more important than ever for public companies to limit the number of executives (perhaps even to only one) who are authorized to speak to analysts and institutional investors.” Todd R. David & Kelly C. Wilcove, *New S.E.C. Regulations Address Selective Disclosure and Clarify Insider Trading Standards*, SECURITIES LAW ADVISORY, Aug. 2000, available at <<http://www.alston.com/docs/advisories.htm>>.

161. “If they [issuers] open up their offices and factories to analysts, there will likely be shrewd operators who make money. If that happens, the information egalitarians at the S.E.C. may be offended and start disciplinary actions. This will likely start private suits as well.” Kevin A. Hassett, *Outlaw Selective Disclosure?*, THE WALL STREET JOURNAL, Aug. 10, 2000, at A18, available in 2000 WL-WSJ 3039742.

alike.<sup>162</sup> It is axiomatic that there exists a plethora of litigation caused by plaintiffs' previous attempts to set implied actions to S.E.C. music, even without such clear prompting by the Commission. In this realm, the very flexible standard by which such implied actions sound or are silenced often speaks not to the S.E.C.'s wishes but rather to Congressional intent and "a causal connection between the alleged fraud and the harm incurred" by the purchase/sale of the security.<sup>163</sup>

It is worth reiterating that analysts have been sued for civil 10b-5 liability (even post-*Dirks*) where it is not clear what tangible benefit accrued to their tipper.<sup>164</sup> Thus, although the Commission states that it is not the intention to create implied causes of action against those who violate Regulation FD, this sentiment is not dispositive. Indeed, it has been held that the two-prong test for discerning whether a private action exists under 10b-5 focuses on broader issues, namely: (1) whether the *statute* underlying the S.E.C. rule permits an implied cause of action<sup>165</sup> and (2) whether a private right of action under the statute *should be* implied from the agency rule at issue.<sup>166</sup> Noticeably absent from this two-prong test is the intent of the S.E.C. to include/preclude private rights of action at the time of the adoption of a particular rule.<sup>167</sup>

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162. See, *Baxter v. A.R. Baron & Co.*, No. 94 Civ. 3913, 1996 U.S. Dist. LEXIS 15098, at \*29-30 (S.D.N.Y. Sept. 30, 1996) (private 10b-5 action based in part on an issuer's failure to file a Form 8-K; court dismissed claim because plaintiff failed to plead reliance); *In re American Continental Corp./Lincoln S&L Sec. Litig.*, 794 F.Supp. 1424, 1446 (D.Ariz. 1992) (motion for summary judgment denied where 10b-5 claims premised in part upon accounting firm's agreeing with statements in issuer's Form 8-K).
163. *Arst v. Stifel, Nicolaus & Co.*, 86 F.3d 973, 977 (10th Cir. 1996) (finding an implied cause of action under S.E.C. Rule 10b-16, which sets forth the disclosure duties of broker-dealers regarding credit terms in margin transactions).
164. *State Teachers Retirement Bd. v. Fluor Corp.*, 576 F.Supp. 1116, 1121 (S.D.N.Y. 1983) (held that, although it was "unclear" how selective disclosures to the tippee analysts would increase the stock's price, that issue would be "placed before the jury").
165. Of course, implied rights of action under 10b-5 have existed for over 50 years and have been blessed by the Supreme Court for close to 30 years. See, *Kardon v. National Gypsum Co.*, 69 F.Supp. 512, 514 (E.D. Pa. 1946); *Superintendent of Ins. v. Bankers Life and Cas. Co.*, 404 U.S. 6, 13 n.9 (1971) (court acknowledged that it was "established" that a private action under 10b-5 existed). Separately, private rights of action under the securities laws have been described by the Supreme Court as a "judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).
166. See, *Kardon*, 69 F.Supp. at 514; *Superintendent of Ins.*, 404 U.S. at 13 n.9; *Blue Chip Stamps*, 421 U.S. at 737.
167. *Angelastro v. Prudential-Bache Sec., Inc.*, 764 F.2d 939, 948 (3rd Cir. 1985), *cert. denied*, 474 U.S. 935 (1985). See also, *Metzner v. D.H. Blair & Co.*, 689 F.Supp. 262, 267 (S.D.N.Y. 1988) (referencing the "excellent analysis" present in *Angelastro*); *Greenblatt v. Drexel Burnham Lambert, Inc.*, 763 F.2d 1352 (11th Cir. 1985); *Robertson v. Dean Witter Reynolds, Inc.*, 749 F.2d 530 (9th Cir. 1984).

Logically, few parties would agree that more 10b-5 caselaw is the answer. The only thing that the circus of Rule 10b-5 interpretations of selective disclosure has made clear to date is that the fates of issuer and analyst are hopelessly intertwined. An analyst will be liable as a "tipper" to his clients only if he recommends trades after information "tipped" to him by the issuer turns out to have been material and nonpublic.<sup>168</sup> Likewise, the issuer can only be found liable as "tipper" if the "tippee" analysts (or further "tippees") actually trade.<sup>169</sup> Yet, neither has been given much guidance from the S.E.C. as to when illegal information has passed between them, leaving both groups vulnerable to exponentially growing lawsuits under any extended applications of 10b-5. Ironically, the Final Release, while attempting to disconnect issuers allegedly linked to their favorite analysts, has once again hopelessly intertwined their fates: Issuers are obliged to recognize "circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information,"<sup>170</sup> while the disciplinary fate of all securities market professionals to whom information is disclosed is dependent totally upon whether the issuer (a) has imparted material non-public information and (b) done nothing to remedy the situation through immediate or prompt public disclosure.

Thus, while the goal of a completely level playing field is perhaps laudatory, in the puzzle of corporate disclosure, an even more active securities fraud docket is a poor substitute for the missing piece. To be sure, litigation has not exactly prompted issuers into open communications with the public to date. In the Regulation FD debate, corporate management was quick to realize that lawsuits would result from further imposition of duties without definition of key terms, prompting one Silicon Valley executive to utter, "In a broad sense, almost any comment could be considered *material*."<sup>171</sup>

## B. A Suggestion

If the Commission is wedded to the route of adopting existing caselaw, surely the vast terrain of court decisions provides an ample framework for a laundry list of "do's" and "don'ts" for issuers and analysts. Apart from the concept of fundamental fairness, such a focus on *materiality* has the added

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168. *Elkind v. & Liggett & Myers, Inc.*, 635 F.2d 156, 167 (2d Cir. 1980).

169. *Shapiro v. Merrill Lynch, Inc.*, 353 F.Supp. 264, 278 (S.D.N.Y. 1972), *aff'd*, 495 F.2d 228 (2d Cir. 1974).

170. 17 C.F.R. § 243.100(b)(1)(iv) (1999) (Regulation FD's "Rule 100(b)(1)(iv)").

171. See, Matt Marshall, *Securities Firms Debate Wider Disclosure of Information*, SAN JOSE MERCURY NEWS, Mar. 1, 2000, at 1, available at 2000 WL 14922534 (emphasis added).

benefit of providing concrete guidelines for both the issuer and the analyst, for the would-be "tipper" as well as the purported "tippee." This task has at least been flirted with at the Commission, as evidenced by the Proposal's references to, and reliance upon, civil cases like *Stevens* and *Liggett & Myers*,<sup>172</sup> and by the Final Release's inclusion of several examples of *material* events.<sup>173</sup>

The judiciary has already lent a hand to the task of outlining proper behavior. For example, the courts have supported the recording and transcribing of conference calls with analysts by ruling resulting transcripts admissible.<sup>174</sup> The courts (and the S.E.C.) have previously advised reporting companies not to share internal projections.<sup>175</sup> The courts have, without much issue, decreed that the failure to disclose forecasts is not actionable<sup>176</sup> and that predictions in and of themselves cannot be actionable.<sup>177</sup>

Additionally, the courts have agreed that the federal securities laws "do not ordain that the issuer of a security compare itself in myriad ways to its competitors, whether favorably or unfavorably."<sup>178</sup> Also, there seems to be no duty to disclose information about the industry, which is already "well understood"<sup>179</sup> or where the market has knowledge because of information on file with the S.E.C.<sup>180</sup> Simply put, since the Commission has stamped its imprimatur on *Basic v. Levinson*, *TSC Indus. v. Northway*, and *Elkind v. Liggett & Myers*, then why not adopt the other cases mentioned above as well?

The Commission admits: "We recognize that materiality judgments can be difficult. Corporate officials may therefore become more cautious in communicating with analysts or selected investors . . . ."<sup>181</sup> Regrettably, a full list of *material* items is not the road chosen by the S.E.C. at this time. Instead, within the context of incomplete caselaw, Regulation FD appears to represent

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172. Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,598 (1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, and 249) (proposed Dec. 20, 1999).

173. See, note 59, *supra*, and accompanying text.

174. See, *Wenger v. Lumisys, Inc.*, 2 F.Supp.2d 1231 (N.D. Cal. 1998); *Cooper v. Pickett*, 137 F.3d 616 (9th Cir. 1997).

175. See, *Cooper*, 137 F.3d 616.

176. *In re VeriFone Sec. Litig.*, 11 F.3d 865, 867 (9th Cir. 1993).

177. *Rubinstein v. Collins*, 20 F.3d 160, 173 (5th Cir. 1994). See also, RESTATEMENT (SECOND) OF TORTS, § 552 cmt. h. (1977).

178. *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1419 (9th Cir. 1994) (quoting *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 375 (3d Cir. 1993)).

179. *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1119 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990); *In re Convergent Tech. Sec. Litig.*, 948 F.2d 507, 513 (9th Cir. 1991).

180. *Picard Chem., Inc. Profit Sharing v. Perrigo Co.*, 940 F.Supp. 1101, 1123 (W.D. Mich. 1996).

181. Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,594 (1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, and 249) (proposed Dec. 20, 1999).

an *in terrorem* attempt to pose new obligations and concomitant penalties for indifference thereto.

For those who argue that the mosaic that the S.E.C. is slowly piecing best serves to deter fraud, there is greater evidence of uninformed investors and chilled management. Witness the havoc wreaked last fall when management at the Maytag company, as their stock dropped on a Wednesday and an additional 25 % on Thursday, simply spoke to neither analysts nor the public until a press release disclosing lowered estimates could be prepared for Friday morning.<sup>182</sup> Maytag stock fell again after the Friday press release, a loss occasioned by the company's failure to deliver the bad news in a timely manner, according to one analyst.<sup>183</sup>

Likewise, a lack of definition of the operative terms works to anger the professional and the laymen alike. The Proposal cites to an article in *The Washington Post*, which detailed Hewlett-Packard's late disclosure of the effect of order disruptions overseas on company earnings estimates in 1999.<sup>184</sup> Although the point the Commission attempts to make is that a large issuer seemingly disclosed to a few what should have been told to the many, the article actually illustrates how, even in hindsight, obligations are inextricably linked with definitions.<sup>185</sup>

The details are as follows. In a conference call with analysts on October 1<sup>st</sup>, the company disclosed that among its concerns was the fear of a possible disruption of foreign component flow.<sup>186</sup> Hewlett-Packard posted the transcript of this conference call on its website.<sup>187</sup> About three weeks later, the company answered the queries of particular analysts in a slightly more negative tone, openly acknowledging that some component flow was being disrupted.<sup>188</sup> Apparently, this information was not broadly disseminated.<sup>189</sup> A Merrill Lynch analyst dropped his earnings estimate for the company by a nickel.<sup>190</sup> Other analysts followed suit and the stock had dropped twelve

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182. David Barboza, *Maytag's Lag In Disclosure Costs It Dearly*, THE NEW YORK TIMES, Sept. 15, 1999, at C1, available at 1999 WL 30481820 ("Analysts, accustomed to gentle guidance from all manner of companies, were shocked and angry.").

183. *Id.* (comment of Nicholas Heymann of Prudential Securities, Inc.).

184. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,592.

185. Fred Barbash, *Companies, Analysts A Little Too Cozy*, THE WASHINGTON POST, Oct. 31, 1999, at H1, available at 1999 WL 23312326.

186. *Id.*

187. *Id.*

188. *Id.*

189. *Id.*

190. *Id.*

points before the company issued a press release on October 28<sup>th</sup> disclosing earthquake-related problems in Taiwan.<sup>191</sup>

Angry investors flooded Internet chat rooms with invective centering on the company's seemingly late disclosure of information.<sup>192</sup> But the scenario serves only to heighten the confusion over allocation of blame. Was this *material* information? In hindsight, yes, but perhaps only because the analysts thought so. Stated otherwise, did the analysts' lower estimates between October 1<sup>st</sup> and October 28<sup>th</sup><sup>193</sup> result from, or actually cause, the bulk of the decline? Should the company have issued its press release sooner? Perhaps. But it presumably either did or did not know about an earthquake in Taiwan at the time of its posting of the initial conference call transcript on its website.<sup>194</sup>

More importantly, didn't the analysts here do their jobs by asking questions of management, by "ferreting" out information? Simply put, the *what* that issuers must impart must be determined before the S.E.C. judges *when* and *how* it is "broadly disseminated."<sup>195</sup>

### CONCLUSION

The S.E.C. has greatly discounted the role of the analyst in favor of curtailing perceived corporate favoritism. The vehicle for this change is Regulation FD, a rule that, while surely a crowd-pleaser, upon closer scrutiny, fails to pass muster. For despite the S.E.C.'s conclusory statement that the dividing line between proper and improper information to be disclosed is "reasonably clear,"<sup>196</sup> it is not. Despite the homage paid everyday to disclosure of corporate information,<sup>197</sup> it remains a dangerous enterprise. In sum, in insider trading cases, neither the issuer nor the analyst has received much guidance from the S.E.C., nor hope of speedy dismissal from suit by the courts. To the contrary, analysts have arguably borne an inordinate amount

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191. *Id.*

192. *Id.* ("It is particularly frustrating to sit by in ignorance during a sell-off," wrote one investor.).

193. *Id.*

194. *Id.*

195. *See*, Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,605 n.117. *See also*, Final Release at 51,724.

196. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,595.

197. *See, e.g.*, *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980). *See also*, NYSE Listed Company Manual, § 202.05 ("Timely Disclosure of Material News Developments"), available at <<http://www.NYSE.com/listed/listed.htm>>.

of culpability in the eyes of the Commission, whose aggressive allegations in this area were once dismissed by a federal court as a "facile inference."<sup>198</sup>

Moreover, the Proposal and the Final Release, which are both premised upon sketchy models that lump together all size issuers and analysts, do little to enhance the existing prohibition, e.g., that "the duty imposed on a company and its officers is an alternative one: they must disclose material inside information either to no outsiders or to all outsiders equally."<sup>199</sup> While Regulation FD has been cheered even by some analysts who believe that it will lead issuers to choose audiences more democratically,<sup>200</sup> the regulation, with its repetitive emphasis on the penalties for engaging in a practice that "bears a close resemblance . . . to ordinary 'tipping' and insider trading,"<sup>201</sup> may signal a return to the dark days of the 1970s for analysts, when the S.E.C. charged them seemingly for being party to ill-advised comments or for simply being a link in a chain of events surrounding an alleged insider trading scheme.<sup>202</sup>

Although in spirit an admirable effort, Regulation FD poses new threats and avoids the issue: What can and cannot be said to an analyst? As was said in *Bausch & Lomb* and that remains true today, "[t]he permissible scope of corporate communications with security analysts has yet to be authoritatively defined."<sup>203</sup> Further, the Regulation fails to even provide for the analyst, the same sanctuary of public disclosure remedies afforded the issuer.<sup>204</sup>

Surely, a more worthy effort would be to continue the perhaps arduous process of listing what can and cannot be disclosed. Then, if legal confusion, conspiracy theories, and abounding class actions persist, at least they will do so in the name of progress. Right now, the purported improvement most readily endangers the analysts, the professionals to whom, for better or worse, we have entrusted our system of disclosure. "Instead of worrying about someone having an 'unfair' advantage in the stock market, we should applaud any incentives that lead others to do our information processing for us,"

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198. S.E.C. v. Bausch & Lomb, Inc., 565 F.2d 8, 15 (2d Cir. 1977).

199. Liggett & Myers, Inc., 635 F.2d at 165 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)).

200. Lynn Hume, *Insider Trading Fears May Be Exaggerated*, S.E.C. Member Says, THE BOND BUYER, Feb. 17, 2000, at 32 ("Ironically, analysts have also applauded the rules, saying they suggest issuers will not get into trouble for talking to analysts as long as they disclose information publicly.").

201. Final Release at 51,716.

202. See generally, Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,593.

203. S.E.C. v. Bausch & Lomb, Inc., 420 F.Supp. 1226, 1245 (S.D.N.Y. 1976).

204. Specifically, 17 C.F.R. § 243.101(e)(2) ("Rule 101(e)(2)").



recently penned a *Wall Street Journal* columnist.<sup>205</sup> As Professor Homer Kripke presaged over twenty-five years ago, “[t]hose who try to use disclosure rationally are going to use professional help in doing so anyway.”<sup>206</sup>

Nearly every Internet access provider now offers some form of free stock market advice. At a time when the Web is luring the uninitiated to the front lines of investing and consequentially, new types of fraud are growing,<sup>207</sup> do we really want to thin out the ranks of analysts? Probably not. In this persistently undefined area and this new and confusing technological era, while issuers and analysts struggle to find a balance, let us not bounce the tightrope by adding only sanctions, penalties, and fear.

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205. Holman W. Jenkins, Jr., *Smart Investors Let Others Do the Work*, THE WALL STREET JOURNAL, Aug. 16, 2000, at A23, available in 2000 WL-WSJ 3040269. Ironically, the Commission's press conference on its measure to end selective disclosure was itself only selectively disclosed (to the media). See, *Media Advisory on Proposed Selective Disclosure Rule*, reprinted at <<http://www.sec.gov/news/press/2000-110.txt>> (visited Aug. 9, 2000) (reminding the public that the press conference was for “credentialed media only”).

206. Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631, 637 (1973).

207. See, Marcy Gordon, *S.E.C. is Creating a System To Search the Web for Fraud: Major Accounting Firm Opposes the System, Saying It Violates Privacy*, ST. LOUIS POST-DISPATCH, Mar. 29, 2000, at C1, available in 2000 WL 3516781. See also, *S.E.C. Files Civil Fraud Charges Against Online Stockpicker*, THE NEW YORK TIMES, Jan. 6, 2000, at A1, available in 2000 WL 21236973 (describing the charges filed against “Tokyo Joe,” an online analyst alleged to have, among other things, accepted cash from an issuer in return for a favorable recommendation and repeatedly advised his readers on stocks in which he had undisclosed positions).

**APPENDIX 1****(Regulation FD)****§ 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):
  - (1) Simultaneously, in the case of an intentional disclosure; and
  - (2) Promptly, in the case of a non-intentional disclosure.
- (b)(1) Except as provided in paragraph (b)(2) of this section, paragraph (a) of this section shall apply to a disclosure made to any person outside the issuer:
  - (i) Who is a broker or dealer, or a person associated with a broker or dealer, as those terms are defined in Section 3(a) of the Securities Exchange Act of 1934;
  - (ii) Who is: (A) an investment adviser, as that term is defined in Section 202(a)(11) of the Investment Advisers Act of 1940; (B) an institutional investment manager, as that term is defined in Section 13(f)(5) of the Securities Exchange Act of 1934, that filed a report on Form 13F with the Commission for the most recent quarter ended prior to the date of the disclosure; or (C) a person associated with either of the foregoing. For purposes of this paragraph, a "person associated with an investment adviser or institutional investment manager" has the meaning set forth in Section 202(a)(17) of the Investment Advisers Act of 1940, assuming for these purposes that an institutional investment manager is an investment adviser;

- (iii) Who is an investment company, as defined in Section 3 of the Investment Company Act of 1940, or who would be an investment company but for Section 3(c)(1) or Section 3(c)(7) thereof, or an affiliated person of either of the foregoing. For purposes of this paragraph, "affiliated person" means only those persons described in Section 2(a)(3)(C), (D), (E), and (F) of the Investment Company Act of 1940, assuming for these purposes that a person who would be an investment company but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 is an investment company; or
  - (iv) Who is a holder 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.
- (2) Paragraph (a) of this section shall not apply to a disclosure made:
- (i) To a person who owes a duty of trust or confidence to the issuer (such as an attorney, investment banker, or accountant);
  - (ii) To a person who expressly agrees to maintain the disclosed information in confidence;
  - (iii) To an entity whose primary business is the issuance of credit ratings, provided the information is disclosed solely for the purpose of developing a credit rating and the entity's ratings are publicly available; or
  - (iv) In connection with a securities offering registered under the Securities Act, other than an offering of the type described in any of Rule 415(a)(1)(i) - (vi) (§ 230.415(a)(1)(i) - (vi) of this chapter).

§ 243.101 Definitions.

This section defines certain terms as used in Regulation FD (§§ 243.100 - 243.103).

- (a) Intentional. 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.

- (b) Issuer. An "issuer" subject to this regulation is one that has a class of securities registered under Section 12 of the Securities Exchange Act of 1934, or is required to file reports under Section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), including any closed-end investment company (as defined in Section 5(a)(2) of the Investment Company Act of 1940) (15 U.S.C. 80a-5(a)(2)), but not including any other investment company or any foreign government or foreign private issuer, as those terms are defined in Rule 405 under the Securities Act (§ 230.405 of this chapter).
- (c) Person acting on behalf of an issuer. "Person acting on behalf of an issuer" means any senior official of the issuer (or, in the case of a closed-end investment company, a senior official of the issuer's investment adviser), or any other officer, employee, or agent of an issuer who regularly communicates with any person described in § 243.100(b)(1)(i), (ii), or (iii), or with holders of the issuer's securities. An officer, director, employee, or agent of an issuer who discloses material nonpublic information in breach of a duty of trust or confidence to the issuer shall not be considered to be acting on behalf of the issuer.
- (d) Promptly. "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 the issuer of information that the senior official knows, or is reckless in not knowing, is both material and nonpublic.
- (e) Public disclosure.
  - (1) Except as provided in paragraph (e)(2) of this section, an issuer shall make the "public disclosure" of information required by § 243.100(a) by furnishing to or filing with the Commission a Form 8-K (17 C.F.R. 249.308) disclosing that information.

- (2) An issuer shall be exempt from the requirement to furnish or file a Form 8-K if it instead disseminates 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.
- (f) Senior official. "Senior official" means any director, executive officer (as defined in § 240.3b-7 of this chapter), investor relations or public relations officer, or other person with similar functions.
- (g) Securities offering. For purposes of § 243.100(b)(2)(iv):
  - (1) Underwritten offerings. A securities offering that is underwritten commences when the issuer reaches an understanding with the broker-dealer that is to act as managing underwriter and continues until the later of the end of the period during which a dealer must deliver a prospectus or the sale of the securities (unless the offering is sooner terminated);
  - (2) Non-underwritten offerings. A securities offering that is not underwritten:
    - (i) If covered by Rule 415(a)(1)(x) (§ 230.415(a)(1)(x) of this chapter), commences when the issuer makes its first bona fide offer in a takedown of securities and continues until the later of the end of the period during which each dealer must deliver a prospectus or the sale of the securities in that takedown (unless the takedown is sooner terminated);
    - (ii) If a business combination as defined in Rule 165(f)(1) (§ 230.165(f)(1) of this chapter), commences when the first public announcement of the transaction is made and continues until the completion of the vote or the expiration of the tender offer, as applicable (unless the transaction is sooner terminated);
    - (iii) If an offering other than those specified in paragraphs (a) and (b) of this section, commences when the issuer files a registration statement and continues until the later of the end of the period during which each dealer must deliver a prospectus or the sale of the securities (unless the offering is sooner terminated).

§ 243.102 No effect on antifraud liability.

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

§ 243.103 No effect on Exchange Act reporting status.

A failure to make a public disclosure required solely by § 243.100 shall not affect whether:

- (a) For purposes of Forms S-2, S-3, and S-8 under the Securities Act, an issuer is deemed to have filed all the material required to be filed pursuant to Section 13 or 15(d) of the Securities Exchange Act or, where applicable, has made those filings in a timely manner; or
- (b) There is adequate current public information about the issuer for purposes of Rule 144(c) under the Securities Act.

## APPENDIX 2

### (Rule 10b5-1 {in relevant part})

§ 240.10b5-1 Trading "on the basis of" material nonpublic information in insider trading cases.

Preliminary Note to § 240.10b5-1: This provision defines when a purchase or sale constitutes trading "on the basis of" material nonpublic information in insider trading cases brought under Section 10(b) of the Act and Rule 10b-5 thereunder. The law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and Rule 10b5-1 does not modify the scope of insider trading law in any other respect.

- (a) General. The "manipulative and deceptive devices" prohibited by Section 10(b) of the Act (15 U.S.C. 78j) and §240.10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.
- (b) Definition of "on the basis of." Subject to the affirmative defenses in paragraph (c) of this section, a purchase or sale of a security of an issuer is "on the basis of" material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.