Cutting the Party Line: How the SEC Can Silence Persisting Phone Call Tips

Kristen A. Truver

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NOTE

CUTTING THE PARTY LINE: HOW THE SEC CAN SILENCE PERSISTING PHONE CALL TIPS

I. INTRODUCTION

The fundamental premise of the U.S. federal securities laws is full and fair disclosure to all investors regardless of status or number of shares in their portfolios. Then why, after more than seventy years of prohibition, are there still blatant incidents of corporate favoritism and selective disclosure to those privileged few with access to the party line? In 2008, the chief executive officer ("CEO") of a publicly traded company, Mamma.com, personally called one of its most prominent investors to relay material, nonpublic information. The investor allegedly used that information, which he received only by virtue of his status, to avoid a substantial loss. The Securities and Exchange Commission ("SEC") brought charges against the investor for, among other infractions, violation of § 10(b) of the Securities Exchange Act of 1934 ("1934 Act"). However, mysteriously missing from the SEC's


2. See, e.g., SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009), vacated, 620 F.3d 551 (5th Cir. 2010).

3. Id. at 717.

4. Id. at 718.

5. The SEC was established by the 1934 Act to regulate the securities markets. 15 U.S.C. § 78d(a) (2006).

6. Complaint at 1, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009) (No. 03-08-CV-2050-D) [hereinafter Cuban Complaint]. Section 10(b) of the 1934 Act makes it unlawful for any person, by the means of interstate commerce, to employ a deceptive device in connection with the purchase or sale of a security. 15 U.S.C. § 78j(b).
complaint was a cause of action against the CEO who selectively disclosed the material, nonpublic information in the first place.\textsuperscript{7} This is a classic example of selective disclosure, explicitly prohibited by the securities laws and yet no action was initiated against the disclosing CEO or his company.\textsuperscript{8} In light of \textit{SEC v. Cuban},\textsuperscript{9} it must be asked: where did the law get lost?

Prior to government regulation, the U.S. stock market was riddled with incidents of corporate officers abusing their access to inside information and manipulating the market through the selective disclosure of information.\textsuperscript{10} The enactment of the Securities Act of 1933 ("1933 Act")\textsuperscript{11} in conjunction with the 1934 Act\textsuperscript{12} sought to end these practices, reinstating investor confidence in the securities market by promoting fairness among investors through disclosure.\textsuperscript{13} Congress understood that market fairness was equally tied to notions of informational parity as well as the minimization of fraud\textsuperscript{14} and that open disclosure of information that impacts the value of stock is essential to an efficient and fair securities market.\textsuperscript{15} Thus, Congress turned to

\begin{itemize}
\item \textsuperscript{7} Cuban Complaint, \textit{supra} note 6, at 2.
\item \textsuperscript{8} See \textit{generally id.} (the complaint, although stating that the CEO selectively disclosed information, only sought a judgment from the court enjoining the CEO from future securities laws violations and ordering him to pay a civil penalty).
\item \textsuperscript{9} 634 F. Supp. 2d 713 (N.D. Tex. 2009), \textit{vacated}, 620 F.3d 551 (5th Cir. 2010).
\item \textsuperscript{10} See S. REP. NO. 73-792, at 11 (1934).
\item \textsuperscript{11} 15 U.S.C. § 77a–77aa.
\item \textsuperscript{12} \textit{Id.} § 78a–77nn.
\item \textsuperscript{14} Regarding the 1933 Act, Congress stated that:
The purpose of this bill is to protect the investing public . . . .
The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; . . . to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.

S. REP. NO. 73-47, at 1 (1933); see also Victor Brudney, \textit{Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws}, 93 HARV. L. REV. 322, 357, 360 (1979) (noting that the history of securities legislation suggests Congress sought to protect individual investors from informational advantages established by market institutions); Gill North, \textit{Efficiency, Fairness & Irrationality: Incompatible or Complimentary?}, 24 BANKING & FIN. L. REV. 311, 331 (2009) ("[M]arket fairness is most commonly linked to concepts of informational parity, equality of access to information, minimization of fraud, investor protection, and investor confidence in the integrity of the market.").
\item \textsuperscript{15} See S. REP. NO. 73-792, at 3.
\end{itemize}
mandatory disclosure obligations to level the playing field for all investors.\textsuperscript{16}

The securities laws have endured a grueling journey since the institution of the 1933 and 1934 Acts to today's prohibitions. To initially promote compliance with the newly imposed disclosure obligations, the securities laws included antifraud provisions, prescribing punishment for violations such as failure to disclose and fraudulent disclosure.\textsuperscript{17} While § 16 of the 1934 Act prohibits certain trades "[f]or the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer,"\textsuperscript{18} it was not until nearly thirty years after the creation of the federal securities laws that the courts began to prohibit the behavior we now know as insider trading.\textsuperscript{19}

The court in \textit{In re Cady, Roberts & Co.}\textsuperscript{20} employed the antifraud prohibitions of both Acts to create the insider trading offense and further promote fairness through disclosure.\textsuperscript{21} The court prohibited trading on inside information as a violation of Rule 10b-5.\textsuperscript{22} The SEC explained that the antifraud provisions of the 1933 and 1934 Acts combat the "inherent unfairness involved where a party takes advantage of such [nonpublic] information knowing it is unavailable to those with whom he is dealing."\textsuperscript{23} By creating the insider trading offense, \textit{In re Cady} applied the fairness-through-full-disclosure doctrine to secondary trading.\textsuperscript{24}


\textsuperscript{17} Brudney, supra note 14, at 357; see also Alicia Davis Evans, \textit{A Requiem for the Retail Investor?}, 95 VA. L. REV. 1105, 1108 (2009) (stating that Congress's initial intent in establishing a mandatory disclosure framework was to protect investors).

\textsuperscript{18} 15 U.S.C. § 78(p)(b); see Brown, supra note 13, at 98.

\textsuperscript{19} See \textit{In re Cady, Roberts & Co.}, 40 S.E.C. 907, 908 (1961).

\textsuperscript{20} 40 S.E.C. 907.

\textsuperscript{21} Id. at 911.

\textsuperscript{22} Id. at 913-14 (stating that insider trading is fraud under Section 10b and any person who, by some relationship, has access to nonpublic information has a duty to disclose that information).

\textsuperscript{23} Rule 10b-5 is the general anti-fraud provision that has developed into the prohibition on insider trading. Robert Steinbuch, \textit{Mere Thieves}, 67 MD. L. REV. 570, 572 (2008).

\textsuperscript{24} \textit{In re Cady}, 40 S.E.C. at 912.
The violation proved to be more difficult to demonstrate than the SEC had anticipated. Through a muddled configuration of case law, the prohibition on insider trading developed into two main theories: the classical theory for “insiders” and the misappropriation theory for “outsiders.” While the SEC expected that these two theories would facilitate its campaign against insider trading, the already complex case law simply could not encompass the constantly evolving and inventive methods devised to violate the ban on the use of insider information in trading. Thus, the SEC turned to its rule-making power, fashioning piecemeal measures to address specific types of insider trading, including Rule 10b5-2 and Rule 14e-3. Another such measure is Regulation Fair Disclosure (“Regulation FD”).

Regulation FD was adopted in response to concerns surrounding issuers who selectively disclose information to select individuals, which could lead to a loss of confidence in the integrity and fairness of the markets. The classic example Regulation FD seeks to deter is where an

25. See, e.g., Chiarella v. United States, 445 U.S. 222, 230-33 (1980) (reaffirming the classical theory but refusing to extend the prohibition based on that theory to one who was not a corporate insider).


27. SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990) (defining “outsiders” as “persons who are neither insiders of the companies whose shares are being traded, nor tippers of such insiders”). Under the misappropriation theory, a person is liable for a violation of Rule 10b-5 when misappropriating inside information in violation of some fiduciary duty owed to another party. Id. For a discussion on the two prominent theories through which the SEC attempts to curb insider trading, see generally A.C. Pritchard, United States v. O’Hagan: Agency Law and Justice Powell’s Legacy for the Law of Insider Trading, 78 B.U.L. REV. 13 (1998).

28. See, e.g., United States v. Chestman, 947 F.2d 551 (2d Cir. 1991). In Chestman, the defendant traded on material, nonpublic information he received from his wife. Id. at 555. The court refused to imply a duty of trust or confidence between husband and wife and so held that the defendant could not be found liable under the misappropriation theory. Id. at 571.


30. 17 C.F.R. § 240.14e-3(a). In response to the holding in Chiarella, Rule 14e-3 makes it unlawful for any person to be in possession of material information regarding “a substantial step or steps” in the creation of a tender offer if that person received such information directly or indirectly from the offering person, the issuer, or an insider. Id.

31. Id. § 243.100.

32. See Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,592 (proposed Dec. 28, 1999) (to be codified at 17 C.F.R. pts. 240, 243, 249) (“[S]elective disclosure poses a serious threat to investor confidence in the fairness and integrity of the securities markets.”); see also Floyd
issuers offer material, nonpublic information to only privileged individuals and investors based upon the size of their investments and not to the trading public as a whole. A perfect illustration of this behavior is found in the actions of Mamma.com’s CEO in relation to the SEC enforcement action against Mark Cuban. Yet, the SEC’s complaint made no mention of Regulation FD or the unlawful actions of Mamma.com’s CEO. It appears the CEO was able to avoid liability due to a loophole created by Regulation FD for selectively disclosing insiders who hide behind claims of confidentiality agreements.

This Note urges the SEC to revise Regulation FD as it has inadvertently become a shield for those who selectively disclose information rather than imposing liability for such actions. This Note outlines how the SEC’s enactment of Regulation FD, while spurned by admirable intentions to thwart selective disclosure, has led to an unforeseen loophole and how minor alterations will make this regulation more effective in its efforts to promote fairness through disclosure. Similarly, this Note urges the SEC to more effectively apply a revised Regulation FD so that all players potentially involved in an instance of selective disclosure will be on notice to “hang up the phone.”

Part II of this Note discusses the history of the adoption of Regulation FD, highlighting the difficulties of prohibiting selective disclosure through existing insider trading law. It also describes Regulation FD’s early victories in the fight against selective disclosure.

Part III explains the criticisms surrounding the adoption of Regulation FD and its early set backs in the courts. In addition, this section describes how a well-deliberated rule to prohibit selective disclosure in actuality became a shield behind which those who selectively disclose can hide.

Part IV suggests several alterations to Regulation FD whereby the rule’s original intentions can once again be achieved. Through an analysis of several cases, this section highlights how Regulation FD, in
its reformed state, could be effective in battling insider trading. It also suggests that this already existing rule could help combat the SEC’s ongoing war against hedge funds. In conclusion, this Note suggests that a reformed Regulation could put potential players on notice to stop insider trading before it begins, not after the damage has been done.

II. HISTORY OF THE PROHIBITION ON SELECTIVE DISCLOSURE

By enacting the 1934 Act, Congress established a mandatory disclosure system to promote a fair and efficient market. Since its enactment, full disclosure has become a leading doctrine of the federal securities laws. However, the federal securities laws do not require public disclosure of every important business development when it occurs. Furthermore, while the laws urge prompt disclosure as a best practice, timing over corporate disclosures largely remains at the discretion of the issuer. As a result of this discretion, selective disclosure can often occur.

Selective disclosure is the practice in which issuers of publically traded securities “selectively provide material, nonpublic information to certain persons—often securities analysts or institutional investors—before disclosing the same information to the public.” Traditionally, issuers met with analysts to discuss information not yet publically distributed, which could potentially have an effect on the issuer’s stock price.

Such discussions offer an informational advantage to a small group of select investors. These practices could potentially lead to the use of material, nonpublic information as a commodity and to insider trading.
The SEC originally elected to rectify this behavior by imposing liability for insider trading under Rule 10b-5 of the 1934 Act.

A. Judicial Background Regarding Selective Disclosure

Under the rule-making power granted by the 1934 Act, the SEC enacted Rule 10b-5 which prohibits the trading of securities on the basis of material, nonpublic information as it constitutes a manipulative or deceptive device. Information is material if there is "a substantial likelihood that a reasonable shareholder would consider it important" in deciding whether or not to trade. Information is nonpublic if it is disseminated in any way other than a public announcement. Therefore, it would seem that most selective disclosures clearly come within the purview of insider trading liability established under Rule 10b-5. However, the courts have been sympathetic to the realities of the corporate world, recognizing the essential role market professionals dealing with nonpublic information play in the functioning of a corporation.

46. See 17 C.F.R. § 240.10b-5 (2009). Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Id. Insider trading is typically thought to violate clauses (a) and (c) of the rule. Chiarella v. United States, 445 U.S. 222, 225 n.5 (1980).

47. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448-49 (1976) (determining the standard of materiality for proxy solicitation); see Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988). The Court in Basic adopted the TSC Industries standard for materiality in relation to Section 10(b) and Rule 10b-5. Id. at 232.

48. See In re Investors Mgmt. Co., 44 S.E.C. 633, 643 (1971) ("Information is non-public when it has not been disseminated in a manner making it available to investors generally.").

49. See Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,593 (proposed Dec. 28, 1999) (to be codified at 17 C.F.R. pts. 240, 243, 249). Early insider trading case law suggested that traders were required to have equal access to information, which led to an understanding that selective disclosure of material, nonpublic information could lead to liability. Id.; see also SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) ("The only regulatory objective [of insider trading prohibition] is that access to material information be enjoyed equally . . . .").

50. See Chiarella, 445 U.S. at 233 n.16 (recognizing that Congress believed certain market professionals offer a valuable service to the market while in possession of nonpublic information). The Court explained certain exceptions for liability apply to market professionals "based upon Congress' recognition that specialists contribute to a fair and orderly marketplace at the same time they exploit the informational advantage that comes from their possession of [nonpublic..."
One of the SEC’s most noted early attempts to limit the potential harm from selective disclosure occurred in *SEC v. Bausch & Lomb, Inc.* In *Bausch & Lomb*, the SEC attempted to impose liability for violations of §10(b) of the 1934 Act and Rule 10b-5 on Bausch & Lomb’s chairman for selectively disclosing information regarding the company’s future earnings estimate. While the court found that the earnings estimates were material, nonpublic information, it determined that the incident was an isolated occurrence, unlikely to occur again and lacking the required scienter for Rule 10b-5 liability.

The court also acknowledged that although giving analysts direct material, nonpublic information was prohibited, offering “tidbits” of information, having significance only to a skilled analyst in combination with other information, is encouraged to promote an efficient market. *Bausch & Lomb* denied liability for this incident of selective disclosure based on the irrelevancy of the specific information disclosed to the individual, yet acknowledged the possibility of Rule 10b-5 liability to discourage unwanted selective disclosure.

The threat of Rule 10b-5 liability for simple possession of material, nonpublic information was discarded in the Supreme Court’s decision in *Chiarella v. United States*. The SEC attempted to establish liability based on a “parity of information” approach. The “parity of information” approach imposed Rule 10b-5 liability for anyone, insider or not, who was in possession of material, nonpublic information at the time of a securities trade. Instead, the Court held that there must be a breach of trust or confidence before insider trading liability can be enforced.

The Supreme Court’s decision in *Dirks v. SEC* further hindered the SEC’s ability to impose insider trading liability on those engaging in
selective disclosure. The SEC attempted to address selective disclosure in terms of “tipping” material, nonpublic information from an insider to analysts. In Dirks, an analyst received material, nonpublic information regarding consistent fraud occurring in a publically traded company from an insider of that company. The analyst then disclosed the information to his clients and other investors, several of whom later traded on the basis of the information to their profit.

The SEC argued that one who knowingly receives material, nonpublic information from an insider has a duty to disclose the information before trading upon it. Once again, the Supreme Court rejected the argument that a person is subject to liability under Rule 10b-5 for trading while simply in possession of material, nonpublic information provided by an insider. The Court adopted a new standard by which one might be held liable for selectively disclosing information. This standard required that: (1) the insider breached a fiduciary duty to the corporation by making the disclosure; (2) the insider received a direct or indirect benefit for the disclosure; and (3) the recipient of the information breached a duty to the shareholders by trading upon the information received. This standard imposed greater restraints on the SEC in establishing liability for selective disclosure.

The Court’s new standard for liability requires that the recipient owe a duty to the shareholders. Under Dirks, a duty to disclose or abstain from trading might be imposed upon a recipient of material, nonpublic information in one of two ways: (1) the recipient trades based upon the information, knowing it was provided in breach of a duty; or (2) in trading on the information, the recipient breached a confidential relationship with the company.

61. See Dirks, 463 U.S. at 651, 655-56; Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,593.
63. Id.
64. Id. at 651.
65. Id. at 665-67.
66. See id. at 661-63.
67. Id.
68. Id. at 659.
69. See id. at 660 (explaining the facts required to establish a duty to disclose or abstain). The Court in Dirks acknowledged that under certain circumstances an outsider may become a temporary insider of a corporation, creating a duty to disclose or abstain. Id. at 655 n.14 (“[W]here corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant . . . [t]he basis for recognizing this fiduciary duty is . . . that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.”).
The Court also required that the insider personally benefit from the disclosure in order to impose liability. Absent a motivation for personal gain, an insider who selectively discloses material, nonpublic information has not breached a duty to the shareholders. Dirks significantly hindered the SEC’s “ability to pursue insider trading actions in selective disclosure matters, as it was difficult to prove the ‘personal benefit’ nexus underlying any prohibited selective disclosure.” Since the “personal benefit” requirement is most often interpreted as a financial benefit, something rarely received from selectively disclosing information, the Court’s new standards have been widely recognized as permitting selective disclosure. Thus, as an inside-information-as-contraband approach failed, the SEC chose to specifically target types of information through its rule-making power.

B. Regulation FD Is Adopted

Following the SEC’s loss in Dirks, there have been few insider trading cases involving selective disclosure. That is not to say, however, that incidents of selective disclosure are no longer occurring, just that these incidents do not violate the threshold established by the Supreme Court in Dirks. The reported incidents were believed to occur mostly in private meetings or conference calls between analysts or other

70. Id. at 662.
71. See id.
73. See Clay Richards, Selective Disclosure: “A Fencing Match Conducted on a Tightrope” and Regulation FD—The SEC’s Latest Attempt to “Electrify the Tightrope,” 70 MISS. L.J. 417, 425 (2000) (explaining that the Supreme Court’s decision in Dirks has been widely construed to insulate corporate officers and analysts from liability because the “personal benefit” test has been most often of some pecuniary gain, which is not often found in incidents of selective disclosure). But see SEC v. Phillip J. Stevens, SEC Litigation Release No. 12,813, 48 SEC Docket 739 (Mar. 19, 1991) (the SEC alleged a personal gain based on a corporate official’s attempt to protect his reputation).
74. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,593 & n.31 (noting that the only selective disclosure action brought since the ruling in Dirks was SEC v. Phillip J. Stevens).
75. See id. at 72,591-92. In the years preceding the adoption of Regulation FD there had been many publically reported incidents of selective disclosure due to prioritism and influence. See id.
76. See, e.g., George Anders & Robert Berner, Webvan to Delay IPO in Response to SEC Concerns, WALL ST. J., Oct. 7, 1999, at C16 (where SEC “concerns” delayed an IPO but no insider trading action was filed); Susan Pulliam & Gary McWilliams, Compaq Is Criticized for How It Disclosed PC Troubles, WALL ST. J., Mar. 2, 1999, at C1 (despite the SEC’s concerns, the company could not be prosecuted for insider trading because the complaint lacked a “personal benefit” requirement); Randall Smith, Conference Calls to Big Investors Often Leave Little Guys Hung Up, WALL ST. J., June 21, 1995, at C1 (explaining that many conference calls have out-run the SEC’s insider trading regulation for lack of a personal gain).
individuals and not to the public at large.\textsuperscript{77} Understanding that selective disclosure poses a threat to investor confidence in the integrity and fairness of the market, the SEC sought to curb the practice.\textsuperscript{78}

The SEC could have responded to evidence of on-going selective disclosure throughout the market by arguing for an extension of the insider trading doctrine. Recognizing, however, that the insider trading laws are riddled with uncertainties,\textsuperscript{79} the SEC chose to address the problem of selective disclosure through its rule-making powers.\textsuperscript{80} Seventeen years following the set back created by the \textit{Dirks} decision, the SEC overhauled its arsenal by proposing Regulation FD.\textsuperscript{81} On August 10, 2000, the SEC adopted Regulation FD in an attempt to bring "all investors, regardless of the size of their holdings, into the information loop—where they belong."\textsuperscript{82}

1. Requirements

Regulation FD, like the disclosure rules prior to its adoption, does not require that all material corporate developments be disclosed. Instead, it requires that when an issuer chooses to disclose material, nonpublic information, it must do so broadly to the investing public, not selectively to a "privileged few."\textsuperscript{83} The basic premise of Regulation FD, as discussed in Rule 100,\textsuperscript{84} stipulates that whenever an issuer, or someone acting on its behalf, discloses material, nonpublic information to enumerated persons, the issuer must make the disclosure public either "simultaneously" (for intentional disclosures) or "promptly" (for non-intentional disclosures).\textsuperscript{85}

\textsuperscript{77} Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,591-92 & n.11 (citing the National Investor Relation Institute, which reported that 26% of responding companies reported that they engaged in selective disclosure practices); see Colesanti, \textit{supra} note 43, at 4-5 (citing Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,591-92).

\textsuperscript{78} Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,593-94.


\textsuperscript{80} Id. at 639. Congress has granted the SEC power to create rules in order to supplement the securities laws of the United States. See 15 U.S.C. § 77s(a) (2006). Congress granted the commission "authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this subchapter, including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers." Id.

\textsuperscript{81} 17 C.F.R. §§ 243.100-03 (2009).


\textsuperscript{84} 17 C.F.R. § 243.100.

Selective disclosures are "intentional" when the issuer, or a person acting on its behalf, knows or is reckless in not knowing that the information disclosed is both material and nonpublic.\(^8\) Regulation FD requires that disclosures conveyed intentionally be publicly disseminated "simultaneously," but that requirement is not defined.\(^6\) However, "promptly," in reference to non-intentional disclosures, is defined to mean "as soon as reasonably practicable (but in no event after . . . 24 hours)."\(^8\)

Once a disclosure has been made, and Regulation FD applies, the statement must be made "public," as prescribed by Rule 101(e).\(^8\) "Public disclosure," for the purposes of Regulation FD, can be made by filing a Form 8-K\(^9\) or "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."\(^9\) The rule does not stipulate an exhaustive list of methods by which an issuer makes information "public."\(^9\) Rather, the availability of alternative methods allows the issuer to determine how best to achieve non-exclusionary distribution of information to the general public.\(^9\) However, the final release does stipulate several acceptable methods for making a disclosure public, including widely circulated news services and press conferences.\(^9\)

2. Scope

One of the most frequently voiced concerns surrounding the adoption of proposed Regulation FD is the potential for the rule to decrease issuer disclosure due to a fear of liability.\(^9\) While the proposed rule assured issuers that violations of Regulation FD would not provide a basis for private liability,\(^9\) the SEC modified its rule to "provide even greater protection against the possibility of inappropriate liability, and to guard further against the likelihood of any chilling effect resulting from

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87. See 17 C.F.R. § 243.100-03.
89. 17 C.F.R. § 243.101(e); see Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,723.
93. See id. at 51,723.
94. Id. at 51,723-24.
95. Id. at 51,723.
the regulation." To accomplish these goals, the SEC limited the types of personnel covered by the regulation and the types of communications to persons outside the issuer to which the regulation would apply.

The revised scope of Regulation FD narrows the rule's application to enumerated persons who are prohibited from selectively disclosing material, nonpublic information and those for whom the selective disclosure is intended. Regulation FD prohibits an issuer, or anyone acting on behalf of an issuer, from selectively disclosing information.98 For the purpose of Regulation FD, “issuer” applies to nearly all “reporting companies.”99

As proposed, Regulation FD defined a “[p]erson acting on behalf of an issuer” as “[a]ny officer, director, employee, or agent of an issuer, who discloses material nonpublic information while acting within the scope of his or her authority.”100 In response to criticism, the SEC narrowed that definition to “any senior official of the issuer” or “any other officer, employee, or agent of an issuer who regularly communicates [with one of the enumerated categories of persons in Rule 100(b)(1)] . . . or with holders of the issuer’s securities.”101 This definition limits the scope of the regulation to cover only those employees of a company who regularly interact with market professionals or security holders.102

Additionally, as proposed, Regulation FD applied to all communications “to any person outside the issuer.”103 In order to more effectively address the specific problem of “selective disclosure made to those who would reasonably be expected to trade securities on the basis of the information or provide others with advice about securities trading[,]” the SEC narrowed Regulation FD’s scope to only certain enumerated persons in Rule 100(b)(1).104

98. Id. at 51,719.
99. Colesanti, supra note 43, at 7; see Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,725. Regulation FD applies to all issuers “with securities registered under Section 12 of the Exchange Act, and all issuers required to file reports under Section 15(d) of the Exchange Act.” Id. at 51,724.
100. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,611.
102. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,718. By limiting the application of Regulation FD, the SEC understood that not all communications should trigger the regulation. See id. at 51,720 n.36. The regulation does not cover every employee who occasionally may communicate with outsiders. Id. Thus, information disclosed in the course of business would be outside the course of ordinary business. Furthermore, this limitation suggests Regulation FD only imposes liability on egregious acts of selective disclosure by those in positions who should have known better. See id.
Rule 100(b)(1) enumerates four categories of recipients to whom selective disclosure may not be made. The first three categories are market professionals: (1) broker-dealers or a person associated with a broker-dealer; (2) investment advisors, institutional investment managers and associated persons; and (3) investment companies, hedge funds and affiliated persons. The fourth category is a holder of the issuer’s securities, where it is reasonable that such a person would trade on the basis of the selectively disclosed information. Thus, liability for selective disclosure will be limited to situations involving those who could reasonably be expected to misuse the improperly disclosed information.

However, Rule 100(b)(2) specifies three express exclusions to the enumerated persons in Rule 100(b)(1). The first two exclusions are for situations in which any misuse of information would trigger liability under §10(b) of the 1934 Act. These exceptions are: (1) communications to a person who owes the issuer a duty of trust or confidence; and (2) communications made to a person who expressly agrees to maintain the information in confidence. The third exception is for communications made in connection with securities offerings registered under the 1933 Act. These exclusions also recognize the necessity to disclose material, nonpublic information in the course of legitimate business purposes.

105. 17 C.F.R. § 243.100(b)(1).
107. Id. at 51,719-20.
108. See id. at 51,720.
109. 17 C.F.R. § 243.100(b)(2). Prior to October 4, 2010, Rule 100(b)(2) included a fourth exception for a disclosure to a credit rating agency such that the information “is disclosed solely for the purpose of developing a credit rating and the entity’s ratings are publicly available.” Id. § 243.100(b)(2)(iii). As required by the provisions of section 939B of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC amended Regulation FD to remove the exemption provided to disclosures made to statistical rating organizations and credit rating agencies. Removal From Regulation FD of the Exemption For Credit Rating Agencies, 75 Fed. Reg. 61,050 (Oct. 4, 2010) (codified at 17 C.F.R. pt. 243).
111. 17 C.F.R. § 243.100(b)(2)(i).
112. Id. § 243.100(b)(2)(ii).
113. Id. § 243.100(b)(2)(iv). Regulation FD offers exemptions for disclosures made in relation to specified offerings such that issuers would violate §5 of the 1933 Act. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,725. Section 5 places limitation on disclosures that can be made at various intervals during offerings. Id. These exemptions ensure that compliance with Regulation FD will not conflict with the other conditions placed upon an issuer by way of the federal securities laws. Id.
C. Regulation FD in Practice and Early Victories

Following Regulation FD’s adoption in 2000, the SEC sought enforcement for two types of violations. The first concerned “egregious violations involving the intentional or reckless disclosure of information that is unquestionably material.” The second concerned those “who deliberately attempt to game the system either by speaking in code, or stepping over the line again and again.” Concerned with the continued presence of selective disclosure in the market, the SEC brought several enforcement actions in an attempt to illustrate that such behavior would not be tolerated. After overcoming harsh criticism in its infancy, Regulation FD came out swinging with a slew of enforcement actions that met little resistance.

115. Jordan, supra note 72, at 779.
117. Id.
118. See Jordan, supra note 72, at 780-81.
119. Id. at 770 (explaining that soon after Regulation FD’s enactment a more “business-friendly” administration provided stronger opposition to the rule, forcing public hearings before Congress and threatening its continued presence in the SEC’s arsenal against insider trading).
120. See id. at 781-96 (discussing the four-action sweep of regulatory actions in 2002); see also In re Raytheon Co., Exchange Act Release No. 46,897 (Nov. 25, 2002) [hereinafter Raytheon Release], http://www.sec.gov/litigation/admin/34-46897.htm (where the SEC alleged that Raytheon and its chief financial officer (“CFO”) selectively disclosed quarterly earnings guidance to sell-side analysts but not to the public); In re Secure Computing Co., Exchange Act Release No. 46,895 (Nov. 25, 2002) [hereinafter Secure Computing Release], http://www.sec.gov/litigation/admin/34-46895.htm (where the SEC alleged that Secure and its CEO intentionally disclosed news of a newly signed deal to an investment advisory firm and only on the following day did they issue a press release); In re Siebel Sys., Inc., Exchange Act Release No. 46,896 (Nov. 25, 2002) [hereinafter Siebel Systems Release], http://www.sec.gov/litigation/admin/34-46896.htm (where the SEC alleged that the CEO, after noting in a public conference call that the quarterly results were weak, spoke at a nonpublic conference and spoke of the optimistic estimate of upcoming business); Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Motorola, Inc., Exchange Act Release No. 46,898 (Nov. 25, 2002) [hereinafter Motorola, Inc. Release], http://www.sec.gov/litigation/investreport/34-46898.htm (where the SEC alleged that after the CFO issued a press release detailing the expected weakness in the company’s quarterly earnings, he personally called fifteen analysts to further explain his statements but did not issue a revised press release); In re Schering-Plough Corp., Exchange Act Release No. 48,461 (Sept. 9, 2003), http://www.sec.gov/litigation/admin/34-48461.htm (where the SEC alleged that although the company had publically warned of the expected low earnings for the upcoming quarter, the CEO offered more detailed information to select analysts); In re Sanetech PLC, Exchange Act Release No. 50,400 (Sept. 16, 2004) [hereinafter Sanetech Exchange Act Release], http://www.sec.gov/litigation/admin/34-50400.htm (where the SEC alleged that the company offered “corrected” information to analysts and only after those select analysts released their reports did the company release the information to the public); SEC v. Flowserve Corp., Litigation Release No. 19,154 (Mar. 24, 2005) [hereinafter Flowserve Litigation Release], http://www.sec.gov/litigation/litreleases/lr19154.htm (where the SEC alleged the CEO affirmed earnings estimates at a private function for analysts and only several days later did they release the same information to the public). In each of these actions, the defendants settled with the SEC for varying penalties. Jordan, supra note 72, at
On November 25, 2002, after several warnings by the press and the SEC’s former Enforcement Director, Richard Walker, that the practice of corporate selective disclosure would no longer be tolerated, the SEC brought four actions for violations of Regulation FD. The first among this “sweep” of actions targeted Raytheon and its Chief Financial Officer (“CFO”), Franklyn A. Caine. The action alleged that the CFO selectively disclosed earnings guidance to sell-side analysts covering the company. During one-on-one calls to analysts, the CFO offered more detailed information to those selective few, but failed to notify the public as a whole.

The SEC explained that the personal one-on-one phone calls, initiated by the CFO, created discrepancies in information between a small, select group of individuals and the rest of the trading public, precisely the situation which Regulation FD was designed to prevent. Understanding that the company and its officer had blatantly violated the new regulation, Raytheon quickly settled, complying with the court’s cease-and-desist order.

The next action to come amongst this sweep was against Secure Computing Corporation (“Secure”) and its CEO, John McNulty. The SEC claimed that on March 6, 2002, in a conference call with a portfolio manager at an investment advisory firm, the CEO disclosed, against the wishes of the buyer and without publically announcing that same information, that his company had entered into a significant sales contract. The action also claimed that later that day, the CEO responded to an e-mail from a partner of a brokerage firm and implicitly confirmed that there had been a deal. While Secure’s Director of Investment Relations left a message for the CEO explaining that the information was nonpublic and should not have been disclosed, the CEO
did not receive the message until after the wrongful disclosures. Additionally, on March 7, 2002, the CEO again disclosed the information while on a conference call to an institutional investor. It was not until several hours later that the company issued a press release to the public concerning the agreement.

The SEC determined that each disclosure was material and nonpublic but that the March 6 disclosures were non-intentional and warranted prompt public disclosure. However, the SEC determined that the CEO made the March 7 statements intentionally, requiring Secure to make a simultaneous public disclosure. The SEC charged Secure with a violation of Regulation FD for its failure to simultaneously disclose the information when it intentionally disclosed material, nonpublic information. Shortly after the SEC initiated its cease-and-desist proceedings against Secure, the company settled, yielding to Regulation FD.

The first case to impose monetary sanctions for a violation of Regulation FD was the SEC's civil action against Siebel Systems, Inc. ("Siebel"). The complaint alleged that during a public conference call regarding Siebel’s third quarter results, the CEO characterized the company’s upcoming sales as “quite tough through the remainder of the year.” However, at a later, nonpublic conference for select investment professionals, the CEO informed the small invitation-only assembly that the company was “optimistic” about the upcoming sales and that they expected the buying patterns were returning to normal. Siebel did not simultaneously release the CEO's statements to the public at large, resulting in an SEC investigation.

The SEC reasoned that because following the CEO’s statements at the nonpublic conference the stock price increased by 16.5% and a significant number of attendees purchased Siebel stock, the information that was selectively disclosed was both material and nonpublic.

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132. Id.
133. Id.
134. Id.
135. Id.
136. Id.
137. Id.
138. See id.
139. Jordan, supra note 72, at 787-88, 790.
140. Siebel Systems Release, supra note 120.
141. Id.
142. Id.
143. Id. The SEC explained that the information was material because “it significantly altered the total mix of available information.” Id. Also, the SEC placed great emphasis on the purchases by certain attendees at the conference who were privy to the material, nonpublic information. Id. This
Furthermore, because the statements were intentional, the failure to simultaneously disclose the information to the public was a direct violation of Regulation FD. Siebel agreed to pay a $250,000 civil penalty, although they refused to admit or deny the SEC's allegations. The action was both initiated and settled in November 2002, signaling to the nation that Regulation FD was a significant force in the SEC arsenal against insider trading.

Finally, in a surprising decision, but an illustration of the SEC’s limited tolerance for unintentional violations of the new regulation, the SEC chose to issue a 21(a) Report of Investigation (“Report”) against Motorola, Inc. (“Motorola”) instead of initiating an enforcement proceeding. The Report stated that in January and February 2001, Motorola disclosed to the public that the upcoming quarter sales estimates would be low due to a “significant” weakness in order input. The company never defined “significant.” Based upon this information, market analysts compiled earnings estimates for the company. However, after reviewing the estimates, Motorola believed they were too generous and beyond its reach. Fearing Motorola would be unable to accomplish the estimated sales, the Director of Investor Relations called fifteen individual analysts to further define what the company meant by “significant.” Motorola did not simultaneously or promptly disclose the information to the public.

Even though the SEC determined that the information was both material and selectively disclosed, it did not seek to initiate an action against Motorola. Instead, the SEC stated that because Motorola officials had relied in good faith on the instruction of legal counsel, it would not bring an administrative or civil action against the company. The uncontested string of victories allowed the SEC to flex Regulation

emphasis reaffirms the understanding that information that is “material” will alter the market perception of the security, affecting a market participant’s decision to buy, sell, or abstain. See id.

144. Id.
146. See id. at 787-88, 790.
147. Id. at 792, 795.
148. Motorola, Inc. Release, supra note 120.
149. Id.
150. Id.
151. Id.
152. Id.
153. Id.
154. See id. (stating that Motorola’s conduct was inconsistent with Regulation FD because the proper course of action was not to correct information in private but to make the additional information public).
155. Id.
156. Id.
FD’s muscles and notified the markets that the regulation would be exercised to its fullest extent. Unfortunately, at the first sign of trouble, the SEC’s new regulation was put on hold.

III. PARTY LINES ARE INSTALLED AGAIN—THE DOWNFALLS OF REGULATION FD

A. Criticism and Setbacks

Although the SEC quieted most of the concerns that arose from the release of the proposed Regulation FD, several criticisms regarding the regulation remained loudly voiced. The persisting criticisms concern the vague materiality standard of the rule and its effect on dissemination of information throughout the market as well as market volatility. Critics throughout the industry, like the Securities Industry Association ("SIA"), feared that the uncertainties advanced by the use of a general

158. The most frequently stated concern regarding the new regulation centers on the "'chilling effect'" it may have on the information dispersed to the public. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,718 (Aug. 24, 2000) (codified at 17 C.F.R. pts. 240, 243, 249); see also E-mail from Michael S. Caccese, Senior Vice President & Gen. Counsel, Ass’n for Inv. Mgmt. & Research, to Jonathan Katz, Sec’y, Sec. & Exch. Comm’n (Aug. 8, 2000), http://www.sec.gov/rules/proposed/s73199/caccese1.htm (expressing the primary concern that Regulation FD may halt the flow of information from corporations to investors); Letter from Carlos M. Morales, Merrill Lynch & Co., to Jonathan G. Katz, Sec’y, Sec. & Exch. Comm’n (May 5, 2000), http://www.sec.gov/rules/proposed/s73199/morales1.htm (discussing the risks to corporations in inadvertently disclosing inappropriate information and the expected reaction to that fear); E-mail from Sec. Indus. Ass’n, to Jonathan G. Katz, Sec’y, Sec. & Exch. Comm’n (Apr. 6, 2000), http://www.sec.gov/rules/proposed/s73199/spencer1.htm (advocating against the adoption of Regulation FD for several reasons, including the potential “chilling effect” such a regulation would have on the flow of information through the securities markets). The “chilling effect” refers to the effect on the amount of information a corporation releases as the result of fear of an impending SEC enforcement action. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,733. After considering the comments proposed by several concerned market participants, the SEC chose to modify Regulation FD from its original proposal to protect against inappropriate liability. Id. at 51,718-19. First, the SEC narrowed the scope of the regulation so that it did not apply to all communications to persons outside the corporation, but just to those that are “reasonably foreseeable that the security holder will trade on the basis of the information.” Id. at 51,718. Second, in order to ensure that appropriate business communications would not be subject to liability, the SEC limited the types of issuer personnel covered to only senior management and those who regularly communicate with market professionals and securities holders. Id. Third, to ensure that there would be no liability under Rule 10b-5, the SEC included an express provision prohibiting the possibility for violating Rule 10b-5 for non-compliance with Regulation FD. Id. Fourth, to provide additional assurance that issuers would not be second-guessed on materiality judgments, the SEC included clear language that the Regulation will only apply to "'knowing or reckless'" behavior. Id.
materiality standard as opposed to a more concrete definition would cause difficulties for market compliance.160

1. The "Materiality" Problem

The practical problem with issuer compliance when imposing a new regulation results from an inability to determine what would trigger Regulation FD liability.161 Regulation FD applies to disclosure of "'material nonpublic' information about the issuer, which could affect the price of securities.162 While the SEC has defined "nonpublic" as information that has not been made available to the general public,163 the SEC refused to institute a bright line rule for material information relying, instead, on the standard developed in recent case law.164 Under Regulation FD, material information is that which "'a reasonable shareholder would consider important'" and has "'a substantial likelihood'" to alter the mix of information made available.165 Many believe that this reliance on a flexible but ambiguous definition would lead corporations to choose silence over risking Regulation FD liability.166 Furthermore, critics hypothesize that such a decrease in information could also have a detrimental effect on the stability of the market.167

2. Decreased Market Stability

Under Regulation FD, issuers are encouraged to limit information until it is absolutely required, and then to disseminate information to the

160. See E-mail from Stuart J. Kaswell, Senior Vice President & Gen. Counsel, Sec. Indus. Assoc., to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n (Feb. 24, 2000), http://www.sec.gov/rules/other/f4-433/kaswell1.htm. SIA felt that the new regulation would severely undermine the flow of quality information from issuer to investor. Id. SIA warned that Regulation FD would effectively be imposing a "disclose or abstain" obligation on the issuer, which would have an inhibiting influence on the necessary disclosure between issuer and analyst. Id.


162. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,721. The SEC acknowledged that without a bright line rule, decisions regarding materiality would be hard to make. Id. However, the SEC also stated that using a strict test or exhaustive list of "material" items for the purposes of Regulation FD would be too inflexible to satisfy the purposes of the new regulation. Id. Instead, in the eyes of the SEC, Regulation FD would most effectively hinder corporate selective disclosures if the general materiality standard were used to encompass all possible incidents of corporate disclosure. Id.

163. Id.

164. Id.

165. Id. at 51,721 & n.38 (quoting TSC Indus., Inc., v. Northway, Inc., 426 U.S. 438, 449 (1976)).

166. Kobi, supra note 161, at 601.

167. Id. at 601-02.
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market as a whole. While public dissemination does level the information playing field, critics felt that the absence of guidance offered by the filtering of information through professional analysts would cause volatility in prices, acting as a “bombshell on stock prices.” The argument is that less information to the analysts creates less accurate earning estimates by those analysts, which in turn creates more unexpected earning announcements. The “surprise factor” leads to greater volatility in stock prices when the actual earnings are announced.

Additionally, critics feared that direct dissemination of material information to the public would result in an inaccurate interpretation of the corporate information that was once digested by market professionals before releasing it to the public. While individual investors may have access to a greater wealth of information thanks to Regulation FD, the Regulation cannot ensure that the public will know what to do with it. For example, a corporation might release that they have decided to raise prices or sell additional stock. An individual investor could easily interpret such a move as a sign of corporate good health and vitality while an experienced market analyst would be wary of and inquire into the reasons behind such a move. This lack of market expertise is likely to drag individual investors into injurious trades and explosive price swings.

The speculation from a lack of a materiality standard, coupled with the volatility springing from the lessened quality and quantity of information had critics and issuers calling for help. It was the federal courts, not the SEC, that answered the call. While the SEC refused to concretely establish “material information,” the courts finally intervened and more clearly defined what could be considered “material.”

168. Id. 169. Id. at 602. 170. Jordan, supra note 72, at 766. 171. Id. Several instances of the increased price volatility include Intel’s one-day 22% decline in stock prices on September 22, 2000, Home Depot’s 29% decline on October 12, 2000, and Globalstar’s 60% decline on October 30, 2000. Kobi, supra note 161, at 602. 172. Id. at 603. 173. Id. at 603-04. 174. Id. at 603. 175. Id. at 603-04. 176. See id. at 605 (claiming that Regulation FD has chilled the information flow to the market, negatively affecting investors). 177. See SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694, 696, 710 (S.D.N.Y. 2005) (dismissing the SEC’s complaint against Siebel Systems, Inc.). 178. See id. at 704 (dismissing the complaint for failure to allege selective disclosure of material, nonpublic information).
3. Regulation FD Gets Put on Hold

In the early years of its administration, Regulation FD enjoyed a string of unchallenged enforcement actions, targeting the selective disclosures that plagued the market. The first wave of actions met little resistance, for each of the companies charged with violating Regulation FD chose to settle rather than challenge the SEC and its new regulation in court. This winning streak came to a sudden end when Siebel was charged with a second violation of Regulation FD and the federal court determined that the SEC had become too severe in its interpretation of selective disclosure. In SEC v. Siebel Systems, Inc., the court dismissed the SEC’s complaint and criticized the SEC for nitpicking and applying a heightened level of scrutiny to defendant Siebel’s disclosures. The court also echoed the major criticisms of Regulation FD in its opinion.

The SEC filed charges against Siebel’s CFO and Investor Relations Director for violating the cease-and-desist order agreed to under the first enforcement action against the company. The charges alleged that after public announcements indicating the second quarter sales growth was due to the “slipped” first quarter sales and not from new sales, the CFO told attendees at a private institutional investors event that the company’s sales were “good” or “better” with new deals developing. The SEC claimed that these statements were materially different because the second announcement was “significantly more positive and upbeat” than the previous statements. The SEC also alleged that the Investor Relations Director failed to prevent the selective disclosures or require a public disclosure after the fact. This second

180. See supra Part II.C.
181. See Siebel, 384 F. Supp. 2d at 704.
182. 384 F. Supp. 2d 694.
183. Id. The court refused to accept the SEC’s argument that the selective disclosures of the “good” or “better” state of Siebel’s business activity levels and the “building” or “growing” sales pipeline were materially different from prior public disclosures. Id. at 697, 705.
184. See id. at 701-02 (explaining the “chilling effect” Regulation FD has on the information flow in the market and the vagueness of the regulation stemming from an undefined materiality and nonpublic standard).
186. Siebel, 384 F. Supp. 2d at 697.
187. Id. at 698.
188. Siebel Litigation Release, supra note 185.
action against Siebel charged the individual corporate officers with a civil suit and offered an opportunity for companies and the court to challenge the SEC and what was considered an overbearing regulation.  

The court began by reiterating the frequently criticized potential “‘chilling effect’” Regulation FD has on the market as a result of the vague materiality standard. The court discussed how executives’ fear of liability from a “‘post hoc assessment that disclosed information was material’” would cause a decrease in information, generally, to the public. The court also referred to the increased volatility stemming from the limited information flow to the market. Finally, the court criticized the SEC for its refusal to define materiality. However, the court did note that the SEC attempted to remedy the vague materiality standard by enumerating seven categories of information that would most likely be considered material.

The SEC’s refusal to limit materiality by creating a more concrete definition in an attempt to cast a larger net to a bigger group of selective disclosures thus backfired. The agency’s overly aggressive interpretation of its own rule mixed with an excessively flexible materiality standard forced the court to dismiss the action against Siebel and its executives. The court stated that the SEC had scrutinized each word in both statements “at an extremely heightened level,” including verb tense and syntax of each sentence in an attempt to find materially

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189. See Siebel, 384 F. Supp. 2d at 696.
192. Id.
193. Id. at 701-03 (although the SEC acknowledged that determinations of materiality were difficult and it was mindful of the burdens on issuers, it still refused to concretely define “material”). Even while acknowledging the difficulties presented to issuers by Regulation FD, the SEC blindly suggested that in most cases the materiality would be clear. Id.
194. Id. at 702. The seven enumerated categories are: (1) Earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or supplies . . . ; (4) changes in control or in management; (5) change in auditors or auditor notification that the issuer may no longer rely on an auditor’s audit report; (6) events regarding the issuer’s securities . . . ; and (7) bankruptcies and receiverships. Id. While the list offered guidance to issuers and market participants, it was not considered by the SEC to be per se material. Id.
195. See id. at 708. The court noted that, “[a]pplying Regulation FD in an overly aggressive manner cannot effectively encourage full and complete public disclosure of facts reasonably deemed relevant to investment decisionmaking.” Id.
196. Id. at 708-09.
197. Id. at 704.
different information.\textsuperscript{198} This approach, the court explained, had no foundation in the regulation itself.\textsuperscript{199} Instead the appropriate standard is "[f]air accuracy, not perfection."\textsuperscript{200} Furthermore, the court found it particularly significant that the information disclosed did not fit "squarely within the seven enumerated categories listed by the SEC... as being more likely to be considered material."\textsuperscript{201} For these reasons, the court determined that the SEC applied its new regulation in an "overly aggressive manner."\textsuperscript{202}

Since its public scolding, the SEC became much more conservative in pleading Regulation FD violations, resulting in the regulation being rarely enforced.\textsuperscript{203} That said, in 2005 the SEC chose to bring an enforcement action against Flowserve for selectively disclosing information to a small group of institutional investors.\textsuperscript{204} The SEC charged the CEO with a violating § 13(a) of the 1934 Act\textsuperscript{205} and Regulation FD.\textsuperscript{206} The complaint alleged that the CEO of Flowserve selectively disclosed information explicitly reaffirming earnings guidance, thus the SEC stayed conservatively within the bounds of the specifically enumerated categories of material information within which the Siebel Court suggested that the SEC remain.\textsuperscript{207}

The SEC continued to be hesitant and conservative in pleading Regulation FD in actions through 2009, when it brought an action against Christopher A. Black, the CFO of American Commercial Lines, Inc. The SEC alleged that Black sent a personal e-mail to eight sell-side analysts providing additional details about a public statement made in June 2007.\textsuperscript{208} That e-mail told the select analysts that the new earnings estimates would be "about a dime below that of the first quarter" but he did not publically disclose the information.\textsuperscript{209} Although information

\begin{footnotesize}
\begin{enumerate}
\item[	extsuperscript{198}.] Id.
\item[	extsuperscript{199}.] Id.
\item[	extsuperscript{200}.] Id. at 705 (quoting Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195, 1200 (2d Cir. 1978)).
\item[	extsuperscript{201}.] Id. at 708.
\item[	extsuperscript{202}.] Id.
\item[	extsuperscript{203}.] See Michael L. Davitt et al., SEC Renews Focus on Regulation FD, MARTINDALE.COM (Mar. 23, 2010), http://www.martindale.com/securities-law/article_Jones-Day_951320.htm (noting that there were practically no formal actions alleging violations of Regulation FD after 2005).
\item[	extsuperscript{204}.] Flowserve Litigation Release, supra note 120.
\item[	extsuperscript{205}.] Section 13(a) of the 1934 Act requires an issuer to file appropriate documents with the SEC to keep information regarding the company reasonably current. 15 U.S.C. § 78m(a) (2006).
\item[	extsuperscript{206}.] Flowserve Litigation Release, supra note 120.
\item[	extsuperscript{207}.] Amended Complaint at 3, SEC v. Flowserve Corp., No. 1:05CV00612(JR) (D.D.C. Apr. 19, 2005); see Seibel, 384 F. Supp. 2d at 708.
\item[	extsuperscript{209}.] Id.
\end{enumerate}
\end{footnotesize}
regarding earnings estimates is a clear example of material information, the SEC chose to simply settle the case for a meager $25,000—half the $50,000 fine sought in the Flowserve action four years earlier—suggesting a lessening of the SEC’s faith in Regulation FD.\textsuperscript{210} Additionally, for the first time since the implementation of Regulation FD, the SEC chose not to file an action against the corporation as well as the offending executive officer.\textsuperscript{211}

Perhaps the most telling example of the SEC’s increased hesitancy to plead a Regulation FD violation occurred in early 2010 involving State Street Bank and Trust Company (“State Street”).\textsuperscript{212} The allegations described blatant selective disclosure of material, nonpublic information to a select group of investors and yet the SEC did not charge the company with a violation of Regulation FD.\textsuperscript{213} The SEC alleged that State Street sold bonds it claimed were part of an “enhanced cash” fund.\textsuperscript{214} However, by 2007 the fund was almost completely invested in subprime lending investments.\textsuperscript{215} Beginning on July 26, 2007, when the perils of subprime lending were surfacing, State Street sent out a series of communications describing how other investments would be effected, not bothering to inform its investors of State Street’s own involvement in the subprime market.\textsuperscript{216} At the same time, however, State Street informed several select investors of the fund’s subprime concentration,

\textsuperscript{210} Id.; see also Flowserve Litigation Release, supra note 120 (only four years before the administrative proceeding against Black, who sent personal e-mails directly to individual analysts, the SEC inflicted twice the monetary fine against Flowserve’s CEO for simply reaffirming a prior earnings statement).

\textsuperscript{211} Black Administrative Release, supra note 208 (the order named only Black). Although the SEC has brought two enforcement actions for violations of Regulation FD in 2010, the Commission has continued to bring actions only for behavior clearly in violation of Regulation FD and has settled both of these actions for a minimal amount. See SEC Files Regulation FD Charges Against Presstek, Inc. and Its Former CEO, Litigation Release No. 21,443 (Mar. 9, 2010), http://www.sec.gov/litigation/litreleases/2010/lr21443.htm (the SEC settled charges against Presstek for a mere $400,000 where the company was accused of disclosing material nonpublic information regarding Presstek’s financial performance to a managing partner of an investment adviser); see also In re Office Depot, Inc., Exchange Act Release No. 63,152 (Oct. 21, 2010), http://www.sec.gov/litigation/admin/2010/34-63152.pdf (announcing the settlement of the SEC enforcement action against Office Depot, Inc. for $1 million, where the allegations stated that the company made one-on-one calls to analysts to encourage a change in estimates).


\textsuperscript{213} See id.


\textsuperscript{215} Id.

\textsuperscript{216} Id.
thus giving them preferential treatment. Those select investors were able to recover their investments from the bonds while the other investors suffered when the subprime market collapsed in 2008.

Paradoxically, even though the SEC referred to State Street’s actions as “selective disclosure” it charged State Street only with violations of § 17(a) of the 1933 Act. After adopting Regulation FD to address the specific problem of selective disclosure, the SEC has seemingly ceased to enforce it or embrace the rule to its fullest extent. Instead, the SEC relies on other areas of the federal securities laws with which it has had less resistance, conceivably to better ensure a victory. Perhaps the SEC rightfully withdrew its support from Regulation FD because, in light of the Cuban case, the regulation has inadvertently provided a shield for CEO’s and companies who selectively disclose, effectively making the regulation impotent.

B. Reinforcing the Party Lines—Regulation FD Shields Selective Disclosures

By prohibiting a source from divulging material, nonpublic information to outsiders, Regulation FD sought to prevent those privy to the information from making a profit or avoiding a loss at the expense of the trading public. However, with the intention of making Regulation FD more attuned with the demands of ordinary business, the SEC offered several exceptions to the general rule. The result of one of these exceptions was, in essence, to create a shield behind which selectively disclosing issuers and executives can hide.

217. Id.
218. Id. at 3; see Katie Zezima, State Street Gave Some of Its Clients Better Data, N.Y. TIMES, Feb. 5, 2010, at B3.
220. State Street Complaint, supra note 214, at 17-18. Section 17 of the 1933 Act makes it unlawful for any person to obtain money or property in the sale or offer of a security through the use of untrue statements of material fact, omissions of material fact, or devices of fraud or deceit. 15 U.S.C. § 77q(a)(2)–(3) (2006).
221. Compare State Street Litigation Release, supra note 211 (the defendant settled for over $300 million for a violation of § 17(a) of the 1933 Act), with SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694, 696, 701-09 (S.D.N.Y. 2005) (the SEC was unable to prove a violation of Regulation FD).
222. See SEC v. Cuban, 634 F. Supp. 2d 713, 728 (N.D. Tex. 2009), vacated, 620 F.3d 551 (5th Cir. 2010).
224. Id. at 51,719-20.
Rule 100(b)(2) of Regulation FD offers an exception for selective disclosure of material, nonpublic information to anyone (even investors likely to trade on the information) who “expressly agree[] to maintain the disclosed information in confidence.” This exemption was included in the final rule in response to the criticism that if Regulation FD applied to “any person” outside the issuer, it would obstruct the ordinary communication needed to conduct business and have a “‘chilling effect’” on the information dispersed to the market. The industry feared that such a prohibition would “inappropriately interfere with ordinary-course business communications with parties such as customers, suppliers, strategic planners, and government regulators.”

In order to appease the critics and avoid any negative consequences, the SEC limited the scope of Regulation FD so that it did not extend to communications with persons who have agreed to keep the information in confidence. Thus, any issuer or officer will not be subjected to liability regardless of what information is disclosed and to whom, as long as they obtain an explicit confidentiality agreement.

The SEC mistakenly believed that this exception would not diminish the regulation’s effectiveness because any misuse of such information would give rise to liability under the misappropriation theory. Under the misappropriation theory, a person violates section 10(b) and Rule 10b-5 when he misappropriates confidential information in connection with the purchase or sale of securities in violation of a duty owed to the source of the information. Selectively disclosed information subject to this exception would have a duty of confidentiality attached, which if violated would subject the party using the information to insider trading liability. The SEC believed that potential liability would deter exploitation of the selectively disclosed information, protecting the trading public from potential insider trading. However, in light of the Cuban case, the breach of a


227. Id. at 51,719.
228. Id. at 51,720 & n.29.
229. See id. at 51,720.
230. Id.
233. Id. at 51,720 n.27.
confidentiality agreement alone will not trigger insider trading liability under the misappropriation theory.\textsuperscript{234}

In 2009, the SEC brought an action against a private investor, Mark Cuban, under the misappropriation theory of insider trading.\textsuperscript{235} The complaint stated Cuban was the largest known shareholder of a company called Mamma.com at the time of his alleged insider trading.\textsuperscript{236} The SEC alleged that on June 28, 2004, Mamma.com CEO, Guy Faure, contacted Cuban to invite him to participate in the Private Investment in Public Equity ("PIPE") offering.\textsuperscript{237} The CEO claimed he told Cuban he had information to convey but the information would need to remain confidential.\textsuperscript{238} Once Cuban agreed to maintain the information in confidence, the CEO divulged material information regarding the PIPE offering.\textsuperscript{239} Cuban was upset over the possible diluting of shares the PIPE offering posed, but understanding insider trading laws to some extent, he allegedly told the CEO: "'Well, now I'm screwed. I can't sell.'"\textsuperscript{240}

Nevertheless, several hours after the CEO disclosed the information regarding the PIPE offering, Cuban allegedly called his broker to unload his entire 600,000 share holdings.\textsuperscript{241} After Cuban released his holdings, Mamma.com formally announced the offering to the public.\textsuperscript{242} The company's stock saw a 9.3% decrease in value by the end of the trading day.\textsuperscript{243} According to the complaint, Cuban’s fortuitous position as a leading shareholder, which allowed him to be privy to material, nonpublic information, helped him avoid $750,000 in losses.\textsuperscript{244}

\begin{itemize}
\item \textsuperscript{234} See SEC v. Cuban, 634 F. Supp. 2d 713, 725 (N.D. Tex. 2009), vacated, 620 F.3d 551 (5th Cir. 2010) (separating the duty of confidentiality from the duty not to trade); see also Abbe L. Dienstag et al., Texas District Court Dismisses Insider Trading Charges Against Mark Cuban and Holds that Misappropriation Theory Requires Duty Not to Trade, METROPOLITAN CORP. COUNS., Oct. 2009, at 38, 38, available at http://www.metrocorpccounsel.com/pdf/2009/October/38.pdf (explaining that a finding that the duty to not trade is separate from the duty of confidentiality undermines the "spirit and purpose of Regulation FD (if not its letter)").
\item \textsuperscript{236} Id.
\item \textsuperscript{237} Id.
\item \textsuperscript{238} Cuban, 634 F. Supp. 2d at 717.
\item \textsuperscript{239} Id.
\item \textsuperscript{240} Id.
\item \textsuperscript{241} Id. at 718.
\item \textsuperscript{242} Id.
\item \textsuperscript{243} Cuban Litigation Release, supra note 235.
\item \textsuperscript{244} Id.
\end{itemize}
The SEC brought an action against Cuban for insider trading based upon the misappropriation theory.245 The SEC argued that Cuban's agreement to keep the information confidential created a duty, which gave rise to liability under the misappropriation theory.246 Demonstrating the confusing and illusory nature of the misappropriation theory in practice,247 the court stated that while a duty of trust or confidence can be created by a confidentiality agreement, there exists no insider trading liability when a non-fiduciary, like Cuban, does not also agree to refrain from trading on the confidential information or otherwise misappropriating it for personal gain.248 According to the district court, Cuban agreed to keep the information confidential but made no other representations to Mamma.com's CEO.249 He never expressly agreed to not trade on the information he received and so the court dismissed the action against him.250 The court separated the duty of confidentiality from the duty not to trade for the purposes of the misappropriation theory.251 As a result of this ruling, CEOs are free to

245. Cuban, 634 F. Supp. 2d at 717. Under the misappropriation theory, a person violates Section 10(b) and Rule 10b-5 when he misappropriates confidential information in connection to the purchase or sale of securities. United States v. O'Hagan, 521 U.S. 642, 652 (1997).

246. Diensteg et al., supra note 234, at 38.


248. Cuban, 634 F. Supp. 2d at 725, 728. The court explained:

A person who receives material, nonpublic information may in fact preserve the confidentiality of that information while simultaneously using it for his own gain. Indeed, the nature of insider trading is such that one who trades on material, nonpublic information refrains from disclosing that information to the other party to the securities transaction.

Id. at 725.

249. Id. at 728. The SEC attempted to rely on the telephone call where Cuban stated, "Well, now I'm screwed. I can't sell," to show that he entered into an agreement to satisfy the duty necessary for the misappropriation theory of liability. Id. The court chose to understand this statement as an expression of his belief at that instant that it would be unlawful for him to sell his shares on the basis of the information he had just been provided. Id. The court explained that the statement could not "reasonably be understood as an agreement not to sell." Id. Furthermore, the court explained that the fact that the CEO of Mamma.com expected that Cuban would not sell based on the material, nonpublic information is also insufficient to establish an agreement not to sell. Id. ("[A] mere unilateral expectation on the part of the information source—one that is not based on the other party's agreement to refrain from trading on the information—cannot create the predicate duty for misappropriation theory liability.").

250. Id. at 727-28, 731.

251. Id. at 725.
disclose any material, nonpublic information to select investors who may then trade on such information without the fear of liability on either end.

The exemption offered by Rule 100(b)(2) acts to protect any issuer, officer, or director who selectively discloses information from liability for a violation of Regulation FD, as long as they first obtain a confidentiality agreement. By distinguishing the duty of confidentiality from the duty not to trade, the confidentiality agreement exception has become an ineffective measure against preventing insider trading. As the court in Cuban explained, the duty of confidentiality will not invoke a duty needed to impose liability under the misappropriation theory. If a duty is not created for the purposes of the misappropriation theory, a confidentiality agreement will not discourage a party who has obtained material, nonpublic information through selective disclosure to trade on that information. Thus, a CEO wishing to gain favor with a particular investor can avoid liability under Regulation FD through the use of a confidentiality agreement and the investor, although in breach of the confidentiality agreement, can trade on that information and not be subjected to liability for insider trading. Regulation FD, in its current state, has effectively shielded from liability those it originally sought to expose.

While the Court of Appeals for the Fifth Circuit has recently reversed the decision of the district court, it did so by finding the dialogue between Cuban and the CEO contained an express agreement not to trade on the confidential information; leaving undisturbed the question of separating the duty not to trade from the duty of confidentiality. Yet the question still remains: Why not plug the leak at the source?

Neither the court nor the complaint addressed the conspicuously missing names under Cuban’s as co-defendants, Mamma.com and Guy Faure, even though the corporation and the CEO were instrumental in

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253. See Dienstag et al., supra note 234, at 38 (explaining that the court doubts the legitimacy of insider trading violations predicated on the basis of a pre-existing agreement to hold information confidential).
254. See Cuban, 634 F. Supp. 2d at 725.
255. See id.; see also Dienstag et al., supra note 234, at 38 (explaining that a finding that the duty not to trade is separate from the duty of confidentiality undermines the “spirit and purpose of Regulation FD (if not its letter)”).
256. SEC v. Cuban, 620 F.3d 551, 555 (5th Cir. 2010). The Fifth Circuit held that because all circumstances surrounding the selective disclosure suggest that the understanding between the defendant and Mamma.com was that he would not trade on the selectively disclosed information, this creates a duty, which will sustain a claim under the misappropriation theory. Id. at 557-58.
257. See Cuban, 634 F. Supp. 2d at 717-18, 731; see Cuban Complaint, supra note 6, at 1-3.
Cuban's alleged insider trading violations. Furthermore, the actions of the CEO and the corporation in failing to immediately remedy the disclosure looked to be blatant violations of Regulation FD. Several critics believe that this failure to implicate other defendants was a result of overzealous SEC officials searching for the big headlines and big name defendants. A more reasonable and sympathetic explanation is that the SEC could not charge Mamma.com or its CEO for violating Regulation FD because Regulation FD, in its current state, provides a loophole for companies or senior management to divulge material, nonpublic information to select individuals at their discretion, with no threat of liability.

The SEC specifically targeted selective disclosure because of the detrimental effect the practice has had on investor confidence in the market. By adopting Regulation FD, the SEC sought to end selective disclosure and "level [the] playing field" for all investors. However, while attempting to appease the corporate industry, the SEC inadvertently created a loophole that, in light of recent circumstances, has made the regulation moribund. Nonetheless, selective disclosure

258. If not for the information Cuban received from the CEO, he would not have known to trade prior to the public release of the impending PIPE offering. See Cuban, 634 F. Supp. 2d at 717-18.

259. See supra Part II.B.2.

260. Robert Wenzel, The Coming Bizarre Show Trial of Mark Cuban, ECONOMICPOLICYJOURNAL.COM (Nov. 24, 2008, 12:17 AM), http://www.economicpolicyjournal.com/2008/11/coming-bizarre-show-trial-of-mark-cuban.html. Prior to Cuban's indictment, the SEC was investigating Mamma.com concerning its involvement in the alleged insider trading committed by Cuban. Id. Mamma.com issued a press release stating a previously informal SEC investigation had been converted into a formal investigation. See Jim Hedger, Mamma.com Under Formal SEC Investigation, SEARCH ENGINE J., http://www.searchenginejournal.com/mammacom-under-formal-sec-investigation/1577 (last visited Feb. 28, 2011). The release also included a statement by the company explaining that it believes the SEC is looking into matters related to the trading of the company's securities and whether "an individual" acted in concert with members of the company. Id. However, the investigation came to a sudden end just prior to the deposition of Mamma.com's CEO, Guy Faure, regarding Cuban's actions. Wenzel, supra.

261. See 17 C.F.R. § 243.100(b)(2)(ii) (2009). That section of Regulation FD states: "Paragraph (a) of this section shall not apply to a disclosure made . . . [t]o a person who expressly agrees to maintain the disclosed information in confidence . . . ." Id.


264. See id. at 51,720; see also Dienstag et al., supra note 234, at 38 (stating that the decision in the Cuban case, differentiating an agreement to keep information confidential from an agreement not to trade on the information, is directly at odds with Regulation FD, which only applies to disclosures where it is reasonably foreseeable the person will purchase or sell the issuer's securities).
still poses a threat to a fair and efficient securities market\textsuperscript{265} and so Regulation FD, if amended, could once again be an effective arrow in the SEC's quiver against insider trading.

IV. HOW TO RESTORE REGULATION FD TO DISCONNECT THE PARTY LINE

A. Proposed Amendments to Regulation FD

In order to once again make Regulation FD an effective means to deter selective disclosure and the potential for subsequent insider trading, this Note suggests three alterations to Regulation FD. First, the SEC must sacrifice its vague, albeit flexible, materiality standard\textsuperscript{266} for a more clearly defined set of material disclosures. Second, the exemption offered in Rule 100(b)(2) for selective disclosures attached to confidentiality agreements\textsuperscript{267} must be abandoned. Finally, liability for violating Regulation FD should be extended to those who receive the information in addition to those who disclose it.

The SEC's growing hesitancy to plead Regulation FD arose after the court in \textit{Siebel} reprimanded the SEC for its overly broad interpretation of its own rule.\textsuperscript{268} While the SEC's intentions were to expand the application of Regulation FD,\textsuperscript{269} its vague materiality standard prevented the Regulation from being effectively plead.\textsuperscript{270} The court in \textit{Siebel} noted that the SEC would be more successful in pleading Regulation FD if it remained within the seven enumerated examples of what the SEC considered "material" items.\textsuperscript{271}

\begin{itemize}
  \item \textsuperscript{265} See, e.g., Jill E. Fisch & Hillary A. Sale, \textit{The Securities Analyst as Agent: Rethinking the Regulation of Analysts}, 88 Iowa L. Rev. 1035, 1090 (2003) (stating that selective disclosures enable management to buy institutional investor compliance, allowing those investors to profit at the expense of other traders).
  \item \textsuperscript{266} See Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,721.
  \item \textsuperscript{267} 17 C.F.R. § 243.100(b)(2) (2009).
  \item \textsuperscript{268} See SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694, 708 (S.D.N.Y. 2005); supra Part III.A.3.
  \item \textsuperscript{269} Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,721. The SEC explained that it was hesitant to establish a bright line rule for materiality because it believed Regulation FD would not encompass the various types of selective disclosure that plague the securities market; instead, a general material standard would “encompass the necessary flexibility to fit the circumstances of each case.” \textit{Id}.
  \item \textsuperscript{270} See \textit{Siebel}, 384 F. Supp. 2d at 708.
  \item \textsuperscript{271} \textit{Id}.
\end{itemize}
In its final release of Regulation FD, the SEC listed seven categories of information that it would most likely consider material. These are:

1. Earnings information; 2. mergers, acquisitions, tender offers, joint ventures or changes in assets; 3. new products or discoveries, or developments regarding customers or suppliers . . . ; (4) changes in control or in management; (5) change in auditors or auditor notification that the issuer may no longer rely on an auditor’s audit report; (6) events regarding the issuer’s securities . . . ; and (7) bankruptcies or receiverships.

The SEC noted that it was hesitant to establish a bright line rule for materiality as a general rule would encompass the necessary flexibility, casting a bigger net, required for securities regulation. However, the SEC should sacrifice casting a bigger net in order to actually catch fish. If the SEC limits what it considered material disclosures to the seven categories, the courts would be more receptive to Regulation FD pleadings, allowing the SEC to more confidently rely on the regulation to deter selective disclosure.

The second alteration would eliminate Regulation FD’s exemption for material, nonpublic information disclosed to a person “who expressly agrees to maintain the disclosed information in confidence.” While this clause was originally included to protect communications necessary to everyday business, it has removed any potential liability for insiders committing corporate favoritism and, in light of the circumstances of the Cuban case, has rendered the regulation innocuous in ultimately preventing insider trading. With this exemption, insiders are free to disclose any information to preferred investors, who may then avoid the risk of insider liability through the procurement of a confidentiality agreement. By removing the exemption, Regulation FD will reinstate liability for selectively disclosing insiders who divulge information to gain favor with investors and deter future incidents of insider trading, plugging the leak before it has the potential to do any harm.

Additionally, there exists no practical reason for the inclusion of this exemption. The exemption was instituted to protect ordinary

273. Id.
274. Id.
277. See supra Part III.B.
business communications from triggering liability but such communications are protected by the other limitations to the scope of Regulation FD incorporated into the rule. Regulation FD expressly does not extend to disclosures to persons such as attorneys, investment bankers, accountants, and those in connection with a securities offering. The regulation only applies to broker-dealers, investment advisers, investment companies, and holders of the issuer’s securities—persons that are likely to trade on the information. Even without the exception for disclosures to a person who agrees to maintain the information in confidence, Regulation FD would continue to protect legitimate communications without inadvertently protecting corporate favoritism.

The third alteration would impose liability for those on the receiving end of selectively disclosed information. Regulation FD sought to prevent the disclosure of material, nonpublic information so that the potential for insider trading could not be realized. By imposing liability on the recipients of information, Regulation FD can more effectively prevent disclosure of information to persons likely to trade on it. Not only will insiders be deterred from disclosing information but also potential recipients will be encouraged to “hang up the phone.”

With these amendments, the relevant portions of the general rule would read as follows:

(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 and person who received the material, nonpublic information shall make public disclosure of that information:

(1) Simultaneously, in the case of an intentional disclosure; and
(2) Promptly, in the case of a non-intentional disclosure.

(b)(2) Paragraph (a) of this section shall not apply to a disclosure made:

279. See 17 C.F.R. § 243.100(b).
280. Id. § 243.100(b)(2); see also Removal From Regulation FD of the Exemption For Credit Rating Agencies, 75 Fed. Reg. 61,050, 61,050 (Oct. 4, 2010) (codified at 17 C.F.R. pt. 243) (removing the exemption for disclosures made to credit rating agencies).
281. 17 C.F.R. § 243.100(b)(1).
To a person who owes a duty of trust or confidence to the issuer (such as an attorney, investment banker, or accountant); or

ii. In connection with a securities offering registered under the Securities Act.

Through the past decade, the SEC has focused its efforts to curb insider trading on the misappropriation theory, often with little success. The amended and consequently enhanced rule can redirect the SEC’s efforts toward the prevention of insider trading through the regulation of selective disclosure. By reinstating liability for those insiders who selectively disclose information and creating liability for those who receive the information, the SEC can stop the conversation at both ends of the party line.

B. Cases Where Regulation FD Could Have Been (and Should Be) Employed

Often the temptation for headlines and large fines associated with the misappropriation theory entices the SEC away from using Regulation FD in its fight against insider trading. However, this reliance and faith in the post-trade actions can easily leave the SEC without a victory. The following cases exemplify how the SEC could ensure a victory using the amended Regulation FD.

First, the revised Regulation FD would have proved more effective against the blatant corporate favoritism illustrated in the facts surrounding the Cuban case than the use of the misappropriation theory of insider trading. As suggested by the complaint in the Cuban case, the CEO was not held liable for violating Regulation FD based upon the confidentiality agreement between the company and the investor and yet,
insider trading occurred, to the detriment of the market.\textsuperscript{287} Although the court of appeals has upheld the insider trading liability for investors who trade on selectively disclosed information, it has done so only where the particular circumstances establish an accepted duty not to trade.\textsuperscript{288} If the suggested alterations to Regulation FD are adopted, the SEC would no longer need to rely on the unreliable misappropriation theory to attempt to curb this specific behavior.

Under the revised regulation, the CEO would have been liable for a violation of Regulation FD for disclosing information to a preferred investor. The absolute threat of liability likely would have deterred the CEO from making the call. Additionally, imposing liability for receiving such information without an immediate disclosure would have put the plaintiff in Cuban on notice to “hang up the phone.” By strictly prohibiting the information from being disclosed, Regulation FD could have prevented the subsequent insider trading. Thus, regardless of the outcome in the Fifth Circuit, an improved Regulation FD will ease the SEC’s fight against insider trading by fortifying the prohibition against selective disclosure.

Another situation where Regulation FD, in its revised form, would have prevented insider trading occurred in United States v. Kim.\textsuperscript{289} In 2002, the SEC brought an action against Keith Joon Kim for violations of § 10(b) of the 1934 Act and Rule 10b-5 under the misappropriation theory of insider trading.\textsuperscript{290} Kim had attended a social gathering for young CEO’s where he received material, nonpublic information regarding a potential merger.\textsuperscript{291} Although the meeting required attendees to comply with a written confidentiality agreement, Kim allegedly purchased shares of one of the companies engaged in the merger discussions.\textsuperscript{292} When news of the merger was disclosed to the public, the price of the shares increased dramatically, making a substantial profit for Kim.\textsuperscript{293} The SEC argued that Kim violated a duty of trust and confidence owed to the other attendees at the meeting.\textsuperscript{294} However, the court held that an express confidentiality agreement does not provide the basis for the misappropriation theory.\textsuperscript{295} The court further explained that

\begin{itemize}
\item \textsuperscript{287} See supra Part III.B.
\item \textsuperscript{288} Cuban, 620 F.3d at 557-58.
\item \textsuperscript{289} 184 F. Supp. 2d 1006.
\item \textsuperscript{290} Id. at 1009.
\item \textsuperscript{291} Id. at 1008.
\item \textsuperscript{292} Id. at 1008-09.
\item \textsuperscript{293} Id. at 1009.
\item \textsuperscript{294} Id.
\item \textsuperscript{295} Id. at 1015.
\end{itemize}
the agreement only applies to ethics and morality and, without setting forth a fiduciary duty, does not give rise to any legal duties.296

This is a manifest example where material, nonpublic information was disclosed under the protection of a confidentiality agreement and insider trading occurred as a result of that disclosure.297 Information regarding a merger is within the seven categories of "material" items" listed by the SEC and so this disclosure would come clearly within the purview of Regulation FD.298 Had the CEOs at the meeting thought they would be held liable for a violation of Regulation FD, they would not have disclosed the information regarding the potential merger and Kim would not have had an opportunity to trade on that information. Additionally, the revised Regulation FD would impose a duty on Kim to disclose the information once he received it or be liable for a violation of the regulation per se.

Finally, if the SEC were to institute this revised Regulation FD it would be applicable to hedge funds, where the government is currently seeking greater regulation in an effort to better protect the securities markets as a whole.299 Hedge funds are currently hardly regulated, if at all.300 They are exempt from regulation by both the 1933 Act301 and the Investment Company Act of 1940.302 In recent years the SEC has concluded that the potential for fraud in combination with hedge funds' significant role in the securities markets required a revision of the hedge fund rules.303 Due to the fact that hedge funds are not required to

296. Id.
297. See id. at 1008-09.
300. See id. at 9.
301. The 1933 Act includes an exemption from registering for "transactions by an issuer not involving any public offering." 15 U.S.C. § 77d(2) (2006). Additionally, Regulation D provides an exemption from the disclosure requirements of the 1933 Act to issuers who refrain from general solicitation and only issue to "accredited investor[s]." 17 C.F.R. § 230.506(a) (2009). Thus, as long as hedge funds use only private methods of issuing securities and only to select investors, they are not required to comply with the 1933 Act. See id.
302. See 15 U.S.C. § 80a-51. Hedge funds also escape regulation under the Investment Company Act because they are excluded from the definition of an "investment company." Id. § 80a-3(c)(7)(A). Under this section, small, private offerings do not require federal regulation. Id.; see also SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (holding that certain persons "who are shown to be able to fend for themselves" fall outside the intended scope of established regulations).
disclose their holdings, there is vast potential for fraudulent activity, including insider trading through the use of selectively disclosed information.304 However, the SEC’s past efforts to regulate hedge funds have been generally unsuccessful.305

Hedge funds remain a major influence in securities markets and their actions, especially their fraudulent actions, have a significant impact on the market as a whole.306 In its revised form, Regulation FD will lessen the opportunity for hedge funds to participate in fraudulent activity by imposing liability for both disclosing and receiving material, nonpublic information. Regulation FD, as originally adopted, applied to selective disclosures to hedge funds.307 Under the revised rule, hedge funds would be required to simultaneously or promptly disclose any material, nonpublic information they received, thus removing the potential for subsequent insider trading on that information. Regulation FD can provide an avenue through which the SEC cannot only curb insider trading in its already regulated securities, but expand to new areas of regulation, reducing the opportunity for and occurrences of insider trading.

V. CONCLUSION

The SEC has hardly been winning the war on insider trading.308 Even after fashioning the immense patchwork of case law litigated in defense of the misappropriation theory, corporate favoritism and insider


305. In 2004, the SEC enacted a new rule whereby hedge fund managers would be required to register under the Investment Advisers Act of 1940. Registration Under the Advisers Act of Certain Hedge Funds Advisers, 69 Fed. Reg. at 72,054. However, courts have ultimately found no justification for the rule stating that there was no connection between the number of investors in a fund and the underlying policy of the SEC’s rule, which was to mitigate the national impact of hedge funds. See, e.g., Goldstein v. SEC, 451 F.3d 873, 883-84 (D.C. Cir. 2006).


307. See 17 C.F.R. § 243.100(b)(1)(iii) (2009). Rule 100(b)(1)(iii) applies to hedge funds by requiring public disclosure of entities which would be defined as investment companies but for the exclusions set forth in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act. Id.

308. See Capeci, supra note 247, at 821-22, 824 (discussing patchwork litigation and rule making surrounding the misappropriation theory); see also Kamman & Hood, supra note 283, at 376-77 (explaining the limitations of the misappropriation theory with respect to certain disclosures).
trading persists.309 While the SEC may have had several large victories, the headlines and fines are simply not deterring unfair behavior.310 This focus on punishing the act after it has already been committed is not effectively reaching the goals of the insider trading prohibition—increased investor confidence in the fairness of the market.311 Instead, a focus on prevention of the bad act as opposed to the act itself will lessen the opportunities for outsiders to trade on material, nonpublic information and thus promote the overall goals of the securities laws.312

A reinvigorated Regulation FD will refocus the SEC’s efforts on preventing insider trading by requiring both parties to the conversation to disclose the material, nonpublic information or face liability for failure to do so. However, in its current state, Regulation FD is not preventing selective disclosures; rather, it is promoting them. By using an altered, but already established, Regulation FD, the SEC can more effectively combat insider trading, thus increasing investor confidence and promoting the goals of the insider trading prohibition. The adjusted regulation will tell insiders to “shut up” and outsiders to “hang up”—effectively ending the party line.

Kristen A. Truver*

309. See Brodsky & Kramer, supra note 247, at 79-80 (arguing that the current case law surrounding the misappropriation theory has led to insufficient guidance for market participants as to what can or cannot be done with material, nonpublic information); see, e.g., SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009), vacated, 620 F.3d 551 (5th Cir. 2010).

310. See Guttenberg Litigation Release, supra note 304.

311. Spencer Derek Klein, Note, Insider Trading, SEC Decision-Making, and the Calculus of Investor Confidence, 16 Hofstra L. Rev. 665, 666-68 (1988). Klein argues that there is misplaced confidence in the nexus between investor confidence and insider trading prosecutions and that there are, instead, numerous factors that instill investor confidence. Id. at 673-74.

312. See North, supra note 14, at 331 (“[M]arket fairness is most commonly linked to concepts of informational parity, equality of access to information, minimization of fraud, investor protection, and investor confidence in the integrity of the market.”).

* J.D. candidate, 2011; Hofstra University School of Law. Dedicated to my Note Adviser, Professor J. Scott Colesanti, without whom I would not know the first thing about securities, and to my father, Dr. Scott C. Truver, without whom I would not know the first thing about writing. Thank you for your advice and support.