Regulation FD and Amendments to Insider Trading Rules

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The Securities and Exchange Commission ("SEC") has adopted new rules designed to (i) limit the practice of selective disclosure by public companies and (ii) clarify insider trading rules. The new rules will become effective on October 23, 2000. Public issuers should undertake a prompt review of their communication policies and practices to determine what changes, if any, are necessary by reason of the adoption of Regulation FD. If you require any assistance developing or amending corporate communications policies, or have any other questions regarding the new rules, please feel free to contact any of the attorneys listed on the back page of this article.

I. BACKGROUND

For a number of years, the SEC has attempted to limit the practice of selective disclosure by public companies by enforcing existing prohibitions against tipping and insider trading and other theories developed under Rule 10b-5 under the Securities Exchange Act of 1934 (the "Exchange Act"). Because case law surrounding these efforts has not produced results which in the view of the SEC adequately address the problem, the SEC has adopted Regulation FD. This new rule is designed to require that if material nonpublic information is selectively disclosed by designated persons acting on behalf of the company to securities market professionals or existing security holders, it must also be disclosed publicly. Violation of the rule gives the SEC the ability to bring an enforcement action seeking injunctive relief, civil monetary penalties, or a cease and desist order. Regulation FD is expressly intended not to create new duties under the antifraud provisions of the federal securities laws or to create private rights of action. However, selective disclosure may continue to result in potential liability in private or SEC actions based on tipping, insider trading, entanglement or other theories developed under Rule 10b-5.

II. REGULATION FD

The general rule of Regulation FD is simple: When a public company makes a disclosure of material nonpublic information to certain persons who would reasonably be expected to trade on the information (e.g., analysts, brokers, institutional investors and shareholders), the information must also be publicly disclosed. Regulation FD is intended to stop the flow of inside information to analysts and others who then trade on the information themselves, or pass the information on to their clients. Conduct of this nature leads to the "loss of investor confidence in the integrity of our capital markets," the SEC stated in its adopting release.

A. When Does a Duty to Disclose Information to the Public Arise?

1. Issuers Subject to Regulation FD

Regulation FD applies to all companies that are registered under Section 12 of the Exchange Act or file reports under Section 15(d) of the Exchange Act excluding open end investment companies, foreign governments and foreign private issuers.

2. Disclosures by the Issuer Subject to Regulation FD

Regulation FD applies to disclosures by the issuer, or a person acting on its behalf. A "person acting on behalf of the issuer" is defined such that only communications by directors, executive officers, investor relations or public relations officers or other employees or agents who regularly communicate with shareholders or analysts will trigger a duty to disclose information to the public under this regulation. If material nonpublic information is disclosed by a low-level employee, the issuer is not required to disclose the information to the public under Regulation FD (unless the employee was acting upon instructions from a senior official). Similarly, disclosure of material nonpublic information by any of the persons listed above in breach of a duty of trust or confidence owed to the issuer will not be considered a disclosure by a "person acting on behalf of the issuer." Companies should therefore consider confidentiality agreements with employees and corporate communications policies that create such a duty of trust or confidence.

3. Disclosures to Certain Persons

Regulation FD only applies when disclosure is made to certain enumerated persons. Issuers may make disclosures to non-enumerated persons and not be required to disclose the information to the public. The persons enumerated in the statute are the following:

- Brokers or dealers;
- Investment advisers, institutional investment managers or anyone with whom the foregoing are associated;
- Investment companies, or persons affiliated with investment companies; or
- Shareholders of the company when it is reasonably foreseeable that the shareholder will trade on the basis of the nonpublic information. Regulation FD specifically excludes disclosures made to any person that owes a duty of trust or confidence to the issuer (such as an attorney, investment banker or accountant) as well as those who expressly agree to maintain the disclosed information in confidence (e.g., customers, suppliers and strategic partners). It is therefore advisable to obtain confidentiality agreements from potential partners or advisors whenever disclosing material nonpublic information to them. Also excluded are disclosures to firms that issue credit ratings when the disclosure is made for the purpose of developing a credit rating.

Another exclusion is provided for communications made in connection with a registered offering under the Securities Act of 1933 (the "Securities Act"). The SEC deferred to the regulation provided by the Securities Act and its related rules in this context. Regulation FD therefore does not interfere with the "gun-jumping" and other rules limiting the types of communications an issuer may make in connection with a registered offering of securities. For the purpose of the registered offering exclusion, Regulation FD defines the time periods when a registered offering is deemed to begin and end. B. What Information Must be Disclosed? Regulation FD applies only to "material nonpublic" information about the issuer or its securities. The SEC does not define the term "material." Settled case law deems information "material" when "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision. Also, the information must be viewed by the reasonable investor as having a significant effect on the "total mix" of available information. "Nonpublic" means that the information is not generally available to investors.

The SEC has offered some guidance regarding materiality in the adopting release, stating that the following factors should be reviewed carefully to determine whether they are material (but also noting that the following are not per se material):

- Earnings information;
- Mergers, acquisitions, tender offers, joint ventures, or changes in assets;
- New products or discoveries, or developments regarding customers or suppliers;
- Changes in control or in management;
- Change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report;
- Events regarding the issuers' securities -- e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and
- Bankruptcies or receiverships.C. When Must Information be Publicly Disclosed?

If it is determined that an issuer must make public disclosure of material nonpublic information by reason of Regulation FD, the next step is to determine when the issuer must make such disclosure. Regulation FD makes a distinction between "intentional" and "non-intentional" disclosures. Intentional disclosures are those where the person making the disclosure knows, or is reckless in not knowing, that the information being communicated is both material and nonpublic. Non-intentional disclosures are simply those disclosures that are not within the definition of intentional.

Intentional disclosures of information covered by Regulation FD must be made to the public simultaneously with the planned disclosure. In effect, the requirement of simultaneous disclosure prohibits intentional selective disclosure.

Non-intentional disclosures must be made available to the public as soon as reasonably practicable (but no more than 24 hours) after a senior official (i.e., an officer, director, investor relations officer or public relations officer, or similar employee) learns of the disclosure and knows, or is reckless in not knowing, that the information disclosed was both material and nonpublic.

For example, if a conference call is planned among the officers of an issuer and several analysts and the issuer plans to report that it will not meet its earnings estimates, the issuer must disclose this information to the public simultaneously with the conference call. If on the other hand an officer responds to a question on a subject for which a response has not been anticipated and in the course of the response discloses material nonpublic information, a public disclosure would be required as soon as reasonably practicable.

D. How Can Issuers Make the Required Disclosure?

Regulation FD contemplates two ways of making public disclosure. First, the issuer can file a Form 8-K which contains the information required to be disclosed. Second, the issuer can disseminate the information through another method (or combination of methods) that is "reasonably designed to provide broad, non-exclusionary distribution of the information to the public."

Form 8-K was amended contemporaneously with the adoption of Regulation FD to include a new Item 9 where issuers can furnish reports pursuant to Regulation FD. Item 5 (Other Events) was also amended to allow issuers to file reports required by Regulation FD. There is an important distinction between "furnishing" a report under

Item 9 and "filing" a report under Item 5. Information that is disclosed pursuant to Item 9 will not be deemed "filed" for purposes of the Exchange Act, and therefore such information will not be subject to liability under Section 18 of the Exchange Act or Sections 11 and 12 of the Securities Act, while information disclosed pursuant to Item 5 will be deemed "filed" and will be subject to these liability provisions. However, all disclosures on Form 8-K, whether furnished or filed, will remain subject to the antifraud provisions of the federal securities laws.

Alternative methods of disclosure suggested by the SEC include press releases distributed through widely circulated news or wire services (such as Dow Jones, Bloomberg, Business Wire, PR Newswire or Reuters) and announcements made through press conferences or conference calls that interested members of the public may attend or listen to, either in person, on the phone, or on the Internet. The SEC notes that each issuer must use a method, or combination of methods, that is reasonably calculated to make effective public disclosure given the particular circumstances of each issuer.

The SEC stated that, while disclosure on an issuer's own website may be an important component for disclosure, disclosure of information in this manner will not by itself be considered a sufficient method for disclosure. In addition, if, for example, an issuer knows its press releases are routinely not carried by major wire services, a press release alone would not satisfy the requirement that the means of disclosure be reasonably designed to proved broad non-exclusionary distribution. The SEC recommends that in this context, the issuer should use other or additional methods of disclosure, such as distribution of the information to the local media, furnishing or filing a Form 8-K, posting the information on its website and/or using a service that distributes the press release to a variety of media outlets in order to meet this test.

E. What are the Consequences of Violating Regulation FD?

If an issuer fails to comply with Regulation FD, it would be subject to an SEC enforcement action. The SEC could bring an administrative action seeking a cease-and-desist order, a civil action seeking an injunction and/or money penalties. In certain circumstances, the SEC could also bring an enforcement action against an individual acting on behalf of the issuer who is responsible for the violation.

However, violations of Regulation FD by an issuer will not cause the issuer to become the subject of private lawsuits. The SEC recognized that there would be a "chilling effect" on disclosures made by issuers if they feared private liability. Therefore, Regulation FD provides that failure to make a disclosure required only by Regulation FD shall not be deemed a violation of Rule 10b-5 under the Exchange Act, the section that gives private plaintiffs a cause of action. This exclusion does not affect any potential liability an issuer may have for tipping, insider trading, entanglement with an analyst report, failure to correct, or other theories relating to disclosure.

The use of registration statement Forms S-2, S-3 and S-8 is reliant upon the issuer having filed all material reports required by Sections 13 or 15(d) of the Exchange Act. Since Form 8-K is a report required by Section 13 or 15(d), it is important to note that the failure of an issuer to file a Form 8-K required only by Regulation FD will not cause an issuer to become ineligible to use registration statement Forms S-2, S-3 or S-8. Similarly, in order for holders of restricted or control securities to sell such securities in reliance on Rule 144, there must be adequate current public information about the issuer. The SEC provided that a failure to make disclosure required by Regulation FD will not affect whether there is adequate current public information about the issuer for the purposes of Rule 144.

III. AMENDMENTS TO INSIDER TRADING RULES

Concurrently with the adoption of Regulation FD, the SEC adopted two amendments to Rule 10b-5 under the Exchange Act designed to clarify and strengthen the rules dealing with insider trading. The two amendments address the following issues:

- Whether insider trading liability depends on the person being in "knowing possession" of material nonpublic information, or proof that the person "used" the information; and
- The application of the misappropriation theory of insider trading to non-business relationships. A. Rule 10b5-1: What is Trading "On the Basis Of" Material Nonpublic Information?

The insider trading rules, Section 10(b) of the Exchange Act and Rule 10b-5 under the Exchange Act, prohibit purchases and sales of securities on the basis of material nonpublic information about that security or its issuer in breach of a duty of trust or confidence that is owed to the issuer, the shareholders of the issuer or any other person who is the source of the information. Recently, several courts have disagreed on the definition of "on the basis of" material nonpublic information. The disagreement centers around the "use" versus the "knowing possession" standard. The SEC, as well as some courts, believe that a trader should be liable for trading while in "knowing possession" of material nonpublic information. However, other courts have found that a person should not be liable unless the person "used" the inside information during trading. The new rule, Rule 10b5-1, provides that a trader is trading "on the basis of" material nonpublic information if the person was aware of the material nonpublic information when the person made the purchase or sale. Thus, the SEC has chosen to formally adopt a standard closer to the "knowing possession" standard. The SEC states that this standard "reflects the common sense notion that a trader who is aware of inside information when making a trading decision inevitably makes use of the information."

While the Rule 10b5-1 standard is fairly broad, the new rule also provides two affirmative defenses that a person can use to argue that, even though the person was aware of material nonpublic information, the person should not be liable for insider trading because the person did not make use of the inside information in a purchase or sale of securities. First, an affirmative defense is available to both entities and individuals if they satisfy the following factors:

1. Before becoming aware of the material nonpublic information, the person (i) entered into a binding contract to purchase or sell the security, (ii) provided instructions to another person to execute a trade for the instructing person's account, or (iii) adopted a written plan for trading securities; and

2. The contract, instructions or plan must have expressly specified the amount, price and date of the future trades, provided a written formula for determining the amounts, prices and dates or did not permit the person who is aware of the inside information to exercise any subsequent influence regarding the terms of the purchases or sales. Furthermore, no other person may exercise influence over the purchases or sales when such person is aware of material nonpublic information when doing so; and

3. The purchase or sale must have been pursuant to the prior contract, instructions or sale. If the person deviated from the terms of the contract while aware of material nonpublic information, the person is likely to be found liable under the insider trading rules.

An example of the types of activity that could fall within the first affirmative defense include stock repurchase plans by issuers that are adopted when the issuer is not aware of material nonpublic information and that use a formula to determine the amounts, prices and dates of future purchases or that delegate the responsibility for determining these amounts, prices and dates to a person who is not aware of material nonpublic information. Similarly, an employee may adopt a similar plan for exercising stock options and selling the underlying shares.

The second affirmative defense is applicable only to entities. This defense provides that an entity will not be liable if it demonstrates that the individual making the investment decision on behalf of the entity was not aware of the inside information and that the entity had implemented reasonable policies and procedures to prevent insider trading.

B. Rule 10b5-2: What Constitutes a Duty of Trust or Confidence under the Misappropriation Theory? The "misappropriation theory" of insider trading makes a person liable for the trading of securities on the basis of material nonpublic information if the information was obtained in breach of a duty of trust or confidence owed to any person who is the source of the information. This theory has typically been applied when a breach of a duty of trust or confidence arising from an established business relationship creating a reasonable expectation of confidentiality occurred. An unsettled area of insider trading law has been under what circumstances certain non-business relationships, such as family and personal relationships, may provide the duty of trust or confidence required under the misappropriation theory.

The SEC clarifies this issue by adopting Rule 10b5-2, which provides a bright-line test. The rule sets forth three situations in which a person has a duty of trust or confidence for purposes of the misappropriation theory.

A duty of trust or confidence exists when:

- A person agrees to maintain information in confidence;
- Two people have a history of keeping information confidential and thus have created a reasonable expectation of confidentiality; and
- A person obtains material nonpublic information from a spouse, parent, child or sibling.However, an affirmative defense to the third situation exists if the person can demonstrate that no duty of trust or confidence existed because of the facts and circumstances of the family relationship. The SEC specifically did not include domestic partners, step-parents or step-children in the list of enumerated relationships.

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