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## PROPOSED COMMENT LETTER OF THE CORPORATION, FINANCE AND SECURITIES LAW SECTION ON SEC PROPOSED REGULATION FD

The enclosed comment has been drafted for submission by the Corporation, Finance, and Securities Law Section of the D.C. Bar to the U.S. Securities and Exchange Commission in connection with a proposed new rule relating to selective disclosure by publicly held companies. This comment letter expresses general opposition to the proposed rule and states that if the SEC promulgates a rule with respect to selective disclosure it should consider the following points:

- The proposed rule applies to all material disclosures. The comment letter observes that the materiality standard is vague and difficult to apply on a real time basis. The comment letter therefore proposes that, if the SEC is determined to promulgate a rule, the rule be limited to certain clearly identified topics and suggests that the Commission use as a model NASD IM4120, a NASDAQ memorandum that addresses when a company is required to disclose to the Nasdaq information that might affect the value of its securities.
- The proposed rule applies to all communications by all issuer personnel. The comment letter observes that the scope of the proposed rule is very broad and suggests two alternatives. First, the Rule could be limited to disclosures by senior corporate management. Second, the Rule could include a safe harbor with respect to communications by employees other than senior management as long as the company has in place an effective compliance system of supervising, reviewing, and approving communications by junior employees.
- The proposed rule applies to communications to virtually all third parties. The comment letter observes that this is very broad and would interfere with the ability of companies to communicate with actual and prospective customers and suppliers in the ordinary course of business. The proposed rule suggests two alternatives. First, the proposed rule could be limited to communications made primarily for an investment purpose. Second, the proposed rule could be limited to communications made to analysts and institutional investors.

The views expressed herein represent only those of the Corporation, Finance and Securities Law Section of the District of Columbia Bar and not those of the D.C. Bar or of its Board of Governors.

April 28, 2000

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street N.W.
Washington, DC 20549

Re: Proposed Regulation FD - Selective Disclosure (Release No. 32-7787 34-42259, File No. S7-31-99)

Dear Mr. Katz:

This letter is submitted on behalf of the Corporation, Finance and Securities Law Section of the District of Columbia Bar (the "Section") and was prepared by a task force formed by the Section's Committee on Broker-Dealer Regulation and SEC Enforcement.[1] The Section has a high concentration of attorneys who specialize in securities law and SEC enforcement and therefore has substantial expertise on issues relating to the proposed rule. Accordingly, we appreciate the opportunity to submit our views on the proposed Regulation FD concerning selective disclosure. *See* Release No. 33-7787, 34-42259 (December 28, 1999) ("Proposing Release").[2] A separate letter is being submitted on behalf of the Section that comments on proposed Rules 10b5-1 and 10b5-2.

While we share the SEC's concern over selective disclosure, proposed Regulation FD is an unwieldy, unduly overbroad rule that will be difficult for issuers to administer and for the Commission to enforce. Our chief concern with the proposed

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[1] This views expressed herein represent only those of the Corporation, Finance and Securities Law Section of the District of Columbia Bar and not those of the D.C. Bar or its Board of Governors. The members of the task force who participated in the preparation of this letter include Abigail Arms, James Day, Neil Lang, Yoon-Young Lee, Philip Parker, Roger Patterson, John Sturc, Michael Trager, Harry Weiss, and Kenneth Winer. This comment represents the consensus of the participants as a whole and does not necessarily mirror the views of each individual participant or member of the Section.

Regulation is that its expansive scope and the substantial uncertainty characterizing the definitions at its heart raise the legitimate risk that the proposed Regulation, if adopted, may chill legitimate corporate communications with analysts, institutional shareholders, and others. Thus, the Commission should not adopt Regulation FD in its present form.

Should the Commission determine to adopt Regulation FD, the Task Force believes the Commission should address the following issues:

- The Materiality Determination: The proposed regulation covers the dissemination of "material" information. Determinations of materiality are often difficult and time consuming under the best of circumstances, but the proposed regulation would require a company to make this complicated determination on a "real time" basis. Given our experience in counseling clients as to materiality determinations, we believe that it will be exceedingly difficult for them to make such determinations; thus, requiring "real time" determinations of "materiality" may create substantial uncertainty among companies and their counsel and, accordingly, result in less rather than more information being disseminated. To provide certainty in the proposed Regulation FD, and to increase the ease with which companies can comply with the proposed regulation, the Commission should limit the matters that would trigger the requirements of Regulation FD to a specific list; thus, any intentional disclosure of the listed subjects would have to be made simultaneously with public disclosure of the same information. A model for this list can be found in NASD IM 4120-1 relating to disclosure of material information. Public companies are familiar with this list and have been operating

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[2] The Proposing Release also included proposed rules concerning insider trading (Proposed Rule 10b5-1 concerning "use" v. "possession" of material non-public information). The Task Force is filing a

under it for a number of years. The Commission used a similar approach in promulgating the list of matters in Rule 15c2-12(b)(I)(C) that give rise to continuing disclosure obligations of municipal securities issuers.

- The Scope of the Proposed Regulation: We are concerned about the scope of the proposed Regulation. Proposed Regulation FD would cover any disclosure of material information by any employee of a public company acting within the scope of his or her employment to any person outside the issuer. We believe the sweep of the Regulation is too broad in the following respects. First, by covering any disclosure of material information by any corporate employee, Regulation FD would expose public companies to liability on the basis of disclosures made by lower level employees without the knowledge or approval of senior officers. If an employee who is removed, geographically or organizationally, from senior management makes an "intentional" (as defined by Regulation FD) disclosure of "material" non-public information, the issuer may not be in a position to make simultaneous disclosure of such information to avoid liability under the proposed Regulation. Second, the proposed Regulation covers a broader swath of disclosure than the paradigmatic situation of selective disclosure to analysts or large institutional shareholders. Indeed, the proposed Rule could prohibit communications with suppliers, customers, and others in circumstances that do not give rise to the concerns that motivated the Commission to propose Regulation FD.

## 1. Proposed Regulation FD

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separate comment letter addressing its concerns with Proposed Rule 10b5-1.

Proposed Regulation FD addresses the Commission's concern about selective disclosure highlighted by Chairman Levitt on February 27, 1998 in comments at the "SEC Speaks" Conference.[3] In his remarks, Chairman Levitt found troubling the perceived practice of public companies disclosing material news to analysts and institutional shareholders before disclosing the news publicly. Other Commissioners have echoed the Chairman's comments.[4] Despite the concern of Chairman Levitt and other Commissioners, the Commission has largely been prevented from bringing enforcement cases against insider trading based on disclosure to, or trading by, securities analysts because of the Supreme Court decisions in *Chiarella v. United States*[5] and *Dirks v. SEC.*[6]

Therefore, the Commission proposed Regulation FD to provide it with a way to police selective disclosure by issuers. To accomplish the Commission's goal, Regulation FD contains two principal provisions. First, if a public company or anyone acting on its behalf (including any employee acting within the scope of his or her employment) intentionally discloses material information to any person outside the company, the company must simultaneously make public disclosure of the information through filing a Form 8-K, issuing a press release through a widely circulated news or wire service, or via any other form of dissemination that is reasonably designed to provide broad public access. Second, when such disclosure is unintentional, proposed

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3 *See A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading*, Remarks of Chairman Arthur Levitt, February 27, 1998, at SEC Speaks, available at www.sec.gov.

4 *See, e.g., Corporate Communications Without Violations: How Much Should Issuers Tell Their Analysts and When*, Remarks by Laura S. Unger at the 19th Annual Ray Garrett Jr. Corporate and Securities Law Institute, April 23, 1999, available at www.sec.gov.

5 445 U.S. 222, 100 S. Ct. 1108 (1980).

6 463 U.S. 646, 103 S. Ct. 3255 (1983).

Regulation FD would require an issuer to make public disclosure promptly – defined as no later than 24 hours after a "senior official" of the issuer learns of the disclosure.

Proposed Regulation FD therefore poses two significant concerns for issuers and their counsel. First, the determination of "materiality" within the context of Regulation FD may be exceedingly difficult. Second, the scope of the proposed Regulation is quite broad -- encompassing communications by any corporate employee acting within the scope of his or her responsibilities to *anyone* outside the company.[7]

**2. The Problem with a Materiality Determination**

Whether information to be disclosed is "material" depends on whether there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.[8] As reflected in recently issued Staff Accounting Bulletin No. 99, determining whether a particular disclosure is material often requires an assessment of qualitative factors. Under the analysis described in the bulletin, matters that may appear insignificant in isolation can rise to the level of materiality when considered in light of such qualitative factors.[9]

Given the complexity of the materiality determination, particularly in light of the considerations set forth in SAB 99, such determinations are likely to be clear cut only at the extreme margins when the disclosure concerns, for example, significant earnings and other financial information, a significant corporate acquisition, or a significant corporate development like a new mineral discovery or product approval. For other

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7 We are also concerned about the distinction in the proposed Regulation between intentional and non-intentional disclosure of material non-public information and believe the proposed Regulation does not provide adequate guidance as to what constitutes an "intentional" disclosure. To address this point, the Task Force suggests defining a disclosure as "intentional" when the person disclosing the information decides to do so in advance of a meeting or phone call.

8 *Basic, Inc. v. Levinson*, 485 U.S. 224, 108 S. Ct. 978 (1988); *TSC Industries, Inc. v. Northways, Inc.*, 426 U.S. 438, 444-45, 96 S. Ct. 2126, 2130-31 (1970).

information that might be disclosed, however, the materiality determination will be considerably more difficult.

The difficulty of the materiality determination is exacerbated by the circumstances under which an issuer will likely need to determine, for purposes of proposed Regulation FD, whether to make simultaneous public disclosure of information disclosed to persons outside the issuer. These determinations may in fact have to be made during the course of a conversation with an analyst or an institutional shareholder and in response to a specific question in the conversation. Thus, there will need to be a "real time" evaluation of whether a particular answer will disclose material information. This differentiates the determinations mandated by proposed Regulation FD from those that are typically made by public companies and their counsel. Under the normal scenario, public companies and their counsel, in determining the appropriate disclosure in a press release or filing with the Commission, can make the determination with the benefit of time for consideration of this difficult issue. They may not have the luxury of such time for consideration under Regulation FD.

In light of these considerations, the Task Force believes Regulation FD should clearly identify the type of information that would be covered, rather than rely on an issuer's assessment of materiality. We believe such a list would assist public companies, as they prepare for and conduct conference calls or meetings with analysts or institutional shareholders, to determine more definitively when they are approaching the areas in which Regulation FD might be implicated. The added certainty provided by a list of topics that would trigger Regulation FD would also allow issuers and their counsel to better comply with the Regulation by adopting internal corporate policies that

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[9] Staff Accounting Bulletin No. 99, August 13, 1999, available at www.sec.gov.

can be more easily followed by corporate employees who may make disclosures that would violate or give rise to additional obligations with the Regulation.

If the Commission chooses to consider this approach, the Task Force recommends that the Commission adopt a list that is similar to that included in NASD IM 4120-1. That interpretive memorandum addresses when an issuer is required to disclose to the Nasdaq information that might affect the value of its securities or influence investors' decisions regarding the securities and may lead to a trading halt. In providing guidance to issuers as to the categories of information that give rise to this disclosure obligation, IM 4120-1 lists the following:

- a merger, acquisition or joint venture;
- a stock split or stock dividend;
- earnings and dividends of an unusual nature;
- the acquisition or loss of a significant contract;
- a significant new product or discovery;
- a change in control or a significant change in management;
- a call of securities for redemption;
- the public or private sale of a significant amount of additional securities;
- the purchase or sale of a significant asset;
- a significant labor dispute;
- establishment of a program to make purchases of the issuer's own shares;
- a tender offer for another issuer's securities; and
- an event requiring the filing of a current report under the Act.

We believe there are significant benefits to incorporating this or a similar list in proposed Regulation FD. As mentioned above, it would increase the certainty among issuers and enhance compliance with the Regulation. Moreover, issuers have been addressing disclosure issues under IM 4120-1 and are comfortable making such determinations. Finally, adopting this list would promote uniformity in the rules that govern when an issuer needs to make public disclosure of non-public information.

**3. The Broad Scope of Proposed Regulation FD.**

We are concerned that proposed Regulation FD is overly broad. While the Commission proposed the rule in response to reported instances in which issuers disclosed material nonpublic information to selected analysts or institutional shareholders before disclosing that information to the general public, the proposed rule extends far beyond such disclosures. Indeed, the proposed Regulation FD extends to disclosure of information by any corporate employee acting within the scope of his or her duties "to any person outside the issuer."

By covering communications by any corporate employee, the proposed Regulation FD would subject an issuer to liability for disclosure by corporate employees who are not involved in selective disclosure to analysts or institutional investors. Typically, senior corporate officials or employees in the investor relations department are involved in such communications, perhaps assisted by more junior employees on particular technical issues. By extending the coverage to all corporate employees, the proposed Regulation FD will allow the Commission to bring enforcement actions against issuers based on communications by employees who may be far removed, both geographically and organizationally, from senior management of the issuer. Thus, senior management would not have the ability to protect the issuer from liability under the proposed Regulation by policing such communications, preventing the deliberate disclosure of material non-public information, or providing simultaneous disclosure of material non-public information.

To address this concern, we suggest two alternatives. First, as Commissioner Hunt has advocated,[10] the proposed Regulation FD could be limited to communications

[10] Remarks at the 20th Annual Ray Garrett, Jr. Corporate and Securities Law Institute by Commissioner Issac C. Hunt, Jr., April 13, 2000, available at www.sec.gov.

made by or at the direction of senior corporate management or employees whose duties include communication with analysts and institutional shareholders. Second, should the Commission determine to leave the broad sweep of proposed Regulation FD unchanged, the Task Force suggests that the Commission include a safe harbor to address communications by junior corporate employees. Under this safe harbor, an issuer would not be liable for communications by employees other than senior corporate management or employees whose duties include communication with analysts and institutional shareholders so long as the issuer has in place an effective compliance system of supervising, reviewing, and approving communications by such junior employees.

The Task Force also is concerned that proposed Regulation FD could have a substantial, detrimental impact on the ability of companies to conduct business. In this respect we share the concerns expressed by Commissioner Hunt recently that

> proposed Regulation FD is very broad in scope. It would affect nearly every business communication by a corporation. . . . For example, communications with customers, suppliers, and yes, even regulators, absent a confidentiality agreement, may be subject to simultaneous public disclosure. I am unaware, however, of any widespread problems involving trading on material non-public information by a company's customers, suppliers, or regulators. . . . If we have problems with communications with analysts and presentations of road shows then we should limit Regulation FD to them. In my opinion, we have neither the mandate nor the authority to regulate every business communication.[11]

Companies have legitimate business reasons to make selective disclosures of information to customers, suppliers and others.[12] However, if the Commission promulgates proposed Regulation FD, issuers will be at risk of being charged with violating the proposed Regulation FD if its employees engage in legitimate business

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11 Remarks by Commissioner Issac C. Hunt, Jr., before the 26th Annual Cleveland Securities Law Institute on Securities Regulation, February 18, 2000 (available at www.sec.gov).

communications that the Commission and its Staff, with the benefit of hindsight and the disadvantage of only limited familiarity with the industry, conclude imparted information that was material. Accordingly, if the Commission decides to promulgate proposed Regulation FD, the Commission should craft the rule to minimize the impact of the rule on the ordinary business activities of an enterprise.[13]

We understand that the Commission has partially addressed this concern by defining "to any other person outside the issuer" to exclude "temporary" insiders and persons who have expressly agreed to maintain the information in confidence. While this expansive definition partially mitigates the adverse impact of the proposed rule, we believe that this approach will still not address the numerous instances when the issuer lacks the market or legal power to persuade the customer, supplier, regulator or other third party to sign a confidentiality agreement.

We have identified two additional approaches to narrowing the proposed rule. The first approach would limit the proposed rule to disclosures made to analysts and institutional investors.[14] There are, however, at least two arguable defects in this approach. First, this approach does not reach selective disclosure made to persons other than analysts and institutional investors. The Task Force is unaware of issues with this type of selective disclosure that would not be addressed by the prohibition on insider trading under Rule 10b-5. Second, many companies do business with securities firms and institutional investors. For example, a company that markets software to

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12 Illustrative hypotheticals are included in the Appendix to this Comment letter.

13 While the over breadth of the rule will be mitigated if the Commission adopts the alternative described in Part 2 of this Comment, we believe that it would still pose a danger to the ordinary business operations of industry.

14 The advantage of this approach is that, in the vast majority of circumstances, it draws a bright line between disclosures covered by the rule and disclosures not covered by the rule.

assist in the analysis of securities should be able to make selective disclosures to analysts when marketing its software. This defect can be addressed by a narrowly drawn exception.

The second approach would limit the proposed rule to disclosures that the issuer makes primarily for the purpose of assisting the recipient of the disclosure in evaluating the issuer's securities. This approach offers a number of advantages over the first approach. The primary defect in this approach is that it does not draw a bright line between disclosures that are covered and those that are not. When it will be difficult for the SEC to ascertain the primary purpose of the selective disclosure, companies may be disinclined to make selective disclosures that are important to the efficient operation of their businesses.

We believe that the second approach is superior to the first approach. However, even if the Commission decides to proceed with the issuance of a rule governing selective disclosure that incorporates the second approach, we believe that the potential impact of the proposed rule is so substantial that the Commission should seek additional comments on any proposed revisions to the proposed rule before enacting a final rule.

Respectfully submitted,

Corporation, Finance and Securities Law
Section, District of Columbia Bar

## APPENDIX

1. Company S develops and licenses a certain software package at $250/package. A significant potential customer has indicated to Company S that it will terminate its license with Company S's primary competitor and purchase licenses for 100,000 packages of the Company S's software if Company S reduces the price to a $200, a 20% discount from its standard price. Company S notifies the potential customer that it is willing to sell the software to the potential customer at the discount, significantly increasing the likelihood that Company S will obtain this business. Does Company S have to disclose that it has offered this discount and is therefore, based on potential customer's prior representations, likely to receive the business?
2. Company G is a small company that manufacturers and sells computer games. Company G has developed a new game that incorporates cutting-edge graphics and is trying to persuade internet portals to advertise and distribute the game. Company G has not yet generally introduced the game because it does not want to alert the competition to the cutting edge graphics incorporated in the game. However, as part of the marketing of the game, Company G permits internet portals to test the game on focus groups. Internet Provider One tests the game on a focus group and determines that the game has been extremely well received by the focus group. What, if anything, does Company G have to publicly disclose?
3. Company M is developing a new motor. Company M approaches Company F, a manufacturer of industrial fans and asks that Company F to design a fan that will work with its new motor. Before Company F will commit to developing a new fan, it wants to sees the specifications for Company M's new motor and test the prototype. Company M is unwilling to provide a copy of the specifications to Company F until Company F signs a confidentiality agreement but will permit Company F to perform limited tests on a prototype so that Company F can decide whether to sign the agreement. Company M provides the prototype to Company F and the prototype performs very impressively. What does Company M have to disclose publicly?
4. A state bank regulator asks State Bank, an issuer, for copies of State Bank's business plan and projections. The state bank regulator is not willing to sign a confidentiality agreement. State Bank provides copies of its business plan and projections to the state bank regulator. Does State Bank have to disclose these business plans and projections to the public?
5. Company A is sued for an antitrust violation. Plaintiffs seeks discovery of business plans and projections. Company A moves for a protective order. The Court denies the motion and orders Company A to produce these documents without the protection of a protective order. Company A produces the documents. Does Company A have to disclose these business plans and projections to the public?