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Regulation FD at Age 10: Whence and Whither?

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Ten years ago this October, the Securities & Exchange Commission outlawed selective disclosure. The SEC adopted, by a bare majority, Regulation FD.[1] The new rule was controversial from conception. Indeed, the proposed regulation generated the largest number of comments the SEC had ever received during a rulemaking. The opinions expressed were passionate. Individual inves-tors implored the Commission to create a level playing field between them and big institutions. Research analysts warned that the rule would dry up the flow of information from companies to the market.

With the benefit of a decade's experience, we now know that Reg FD was that rarest of creatures: a new regulation that worked as it was de-signed to, and that did not generate unintended adverse consequences. The credit for that goes, in large part, to the public companies that were the subject of the regulation—they adapted promptly to the new regime and complied with it in good faith.

This article takes a look back at the highlights in Reg FD's young life and contemplates some changes that may come with adolescence.

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Birth

The SEC had attempted to address the phenomenon of selective disclosure prior to Reg. FD. When a company provided guidance to the Street through nontransparent means (such as a conference call with analysts), the staff had taken the view that this practice constituted selective disclosure of material information and violated Rule 10b-5. The Commission, however, had failed to persuade courts that it was right. Accordingly, the staff proposed a new rule—"Regulation Fair Disclosure (FD)"—to prohibit conduct that they had not been able to reach under existing authority.[2]

The proposed rule triggered a flood of public comments (nearly 6,000).[3] In general, the comments fell into three buckets. Individual investors—who during the dot-com boom had begun following market news and developments on a real-time basis through websites like Motley Fool and TheStreet.com—complained that institutional investors received an informational advantage over them in the form of nonpublic access to company guidance and updates. For these commenters, the proposed regulation assumed an almost religious status. A second group was the professional research community: analysts, and the investment banks and funds that employed them. This group opposed Reg FD on the ground that it would cause companies to clam up for fear of liability: thus, instead of equalizing access to information, it would diminish it. The third group consisted of representatives of public companies and the investor relations (I/R) community. They worried that the new rule would make their jobs undoable and create traps for well-intentioned corporate spokesmen.[4]

The proposed regulation did not pass without dissent at the Commission. The final vote at the Commission was 3-1 in favor.[5] In order to cobble together a majority, the proponents had to accept various deals that carved out vast exemptions from the reach of Reg FD. For example, the new regulation governed disclosure to analysts or shareholders, but not to journalists. Similarly, Reg FD applied to company executives, but not to the analysts who elicited information from them. Analytically, these provisions made no sense, given the purpose and structure of the regulation, but they were an essential part of the sausage-making process.

Toddlerhood

Three aspects of the time since Reg FD's adoption bear note. The first is the reaction of the corporate I/R community. Although they had prepared for the effective date of Reg FD with trepidation, they rapidly embraced it with open arms. It turned out that the subtle forms of guidance that many companies had used prior to Reg FD were awkward and uncomfortable for the CEO's, CFO's, and I/R officers who had to engage in them. The dicey practice of diminishing analysts' expectations, or "walking the Street down", late in a quarter often seemed like gargling with nitroglycerin. The major changes in I/R practice wrought by Reg FD—disclosing guidance on a webcast conference call; declining to comment on the viability of guidance late in the quarter except through transparent mechanisms—were actually liberating to corporate spokesmen. In short order, public companies complied with the new regime successfully and even with gusto.

The second notable event was the SEC's effort to teach by example. When it first promulgated Reg FD, the Commission emphasized that it viewed the regulation almost in the nature of a best-practices manual, rather than a weapon in its enforcement arsenal.[6] For the first two years, things were indeed quiet on the enforcement front. Then, on Nov. 25, 2002, the SEC fired a volley of Reg FD enforcement proceedings on the same day.[7] The obvious purpose was to remind the corporate world that the SEC Staff meant business, while at the same time providing examples from which I/R types and corporate lawyers could draw lessons. Among the teaching of those cases:

- Reg FD applies to the disclosure of good news as well as bad news;
- Don't provide updates on the quarter at an investor conference unless it is webcast;
- If a company slips-up and inadvertently discloses material information, it can aggravate

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that violation by confirming the disclosure to others afterwards; and

- Going to a lawyer for advice on a Reg FD issue is almost as good as a "get out of jail free" card in Monopoly.

In order to make these points in a particular set of decisions, the SEC had to stretch somewhat. For example, to emphasize the importance of reliance on counsel, the Commission gave Motorola, Inc. a pass for a blatant Reg FD violation. The reason was that the CFO had checked with in-house counsel first. Nevertheless, the advice relied on was so obviously wrong that the Commission noted in a footnote that no other company should ever rely on similar advice.[8]

All in all, though, this simultaneous series of consent decrees was instructive to the corporate community as to the contours of Reg FD and the staff's appetite for Reg FD enforcement proceedings.

But note the phrase "consent decrees." Not a single one of those enforcement proceedings was litigated. In every instance, the target company capitulated, generally in the face of slap-on-the-wrist penalties. Eventually, the exhilaration of "winning without litigating" led the SEC astray. The high-watermark of the enforcement period was a decision involving the former Schering-Plough Corp. (now Merck & Co.). The SEC slapped the company, its CEO, and its I/R officer with $1 million-plus in penalties for presentations to analysts that, while disclosing no new substantive information, included "tone and demeanor" that the SEC claimed sent signals to the attendees.[9] The problem with tone and demeanor are that they are in the ear and eye of the beholder. A corporate executive may not intend to send any information, but cannot control how others perceive it. This "tone and demeanor" codicil to Reg FD threatened to expand the rule itself dramatically. Indeed, in light of Schering-Plough, many executives contemplated banning one-on-one meetings entirely.

The third phase of Reg FD, however, was one in which the SEC, for the first time, had to prove a case in court. It lost big time. The case involved Siebel Systems, Inc., (now part of Oracle Corp.) which had been the subject of one of the earlier consent decrees.[10] The new case involved lunch and dinner meetings with groups of investors in Boston and New York, which allegedly provided material updates on the quarter.[11] Unlike every other case—in which the company caved and accepted a consent decree—Siebel fought back. In the only reported judicial decision on Reg FD, the U.S. District Court for the Southern District of New York excoriated the SEC for a nit-picking reading of the disclosures in question. For example, the Court stated:

> **It would appear that in examining publicly and privately disclosed information, the SEC has scrutinized, at an extremely heightened level, every particular word used in the statement, including the tense of verbs and the general syntax of each sentence. No support for such an approach can be found in Regulation FD itself, or in the Proposing and Adopting Releases.[12]**

In light of the Court's dismissal of the complaint for failure to allege a violation of Reg FD, the Court did not need to reach Seibel's broader argument: that adoption of Reg FD *ab initio* was unlawful.

Since losing the Seibel case, the SEC has not had any other contested Reg FD enforcement proceedings. The handful of consent decrees since then has involved allegations of such blatantly violative conduct that one is surprised that someone at a public company would have committed them.[13]

Adolescence?

As they say in Safe Harbor statements: the following statements are forward-looking, and actual results could differ materially… .

I believe that there is a nontrivial likelihood that the SEC will revisit Reg FD sometime in the current Administration. From a political standpoint, strengthening Reg FD looks like a populist, "pro-small investor" act. If the SEC turns its attention to Reg FD, three areas might attract its attention.

The first is an enforcement matter, rather than an amendment. Reg FD has done an outstanding

job of providing individual investors with access to investment conferences and analyst meetings from which they historically had been excluded. It is now rare for such meetings not to be webcast. Indeed, many companies will decline to appear if their presentation will not be webcast. Typically, however, the formal session is followed by private break-out sessions that are rarely webcast or reported. Some analysts have moved their grilling of executives as to progress of the quarter from the webcast session to the break-out. These break-out sessions could become the next frontier of a reinvigorated Reg FD enforcement campaign.

The second area is the distinction between disclosures to an analyst, which are covered by Reg FD, and disclosures to a journalist, which are not covered. This was never a rational distinction, merely a political deal. One could imagine the Commission revisiting it.

The third area is the reach of the regulation itself: public companies and their executives may be held liable for violations of Reg FD, but not the Wall Street research analyst who elicits the information that results in the violation. Given that relations between the Commission and the investment banking world are not particularly cordial right now anyway, the SEC might take the next step and make "inducing a breach of Reg FD" as much a violation as the disclosure itself.

Regardless of whether the SEC decides to tinker with the regulation in the coming months, the fact remains: Reg FD has been one of the more successful examples of government regulation in recent years. The business community was able to comply with it at relatively little cost. It put individual investors on a more even footing with institutions. And it did all this with relatively little litigation. May it serve as a model for other initiatives in the years to come!

NOTES

1. Regulation FD, 17 C.F.R. § § 243.100 to 243.103 (2009).
2. Selective Disclosure and Insider Trading, Securities Act Release No. 7787, Exchange Act Release No. 42,259, Investment Company Act Release No. 24,209, 64 Fed. Reg. 72,590 (proposed Dec. 20, 1999) (File No. S7-31-99) ("[M]any have viewed *Dirks [v. SEC*, 463 U.S. 646 (1983),] as affording considerable protection to insiders who make selective disclosures to analysts, and to the analysts (and their clients) who receive selectively disclosed information. Although the antifraud provisions of the securities laws do not require that all traders possess equal information when they trade, we believe that our disclosure rules should promote fair treatment of large and small investors by, among other things, giving all investors timely access to the material information an issuer chooses to disclose. Therefore, we are today proposing new rules, which use a different legal approach, to address selective disclosure.").
3. Press Release 2000-112, Securities and Exchange Commission, Commission Votes to End Selective Disclosure (Aug. 10, 2000), *available at* http://www.sec.gov/news/extra/endseldi.htm.
4. Comment, Boris Feldman, Proposed Regulation FD, File No. S7-31-99, *available at* http://www.sec.gov/rules/proposed.shtml.
5. Commissioner Laura. S. Unger, *Special Study: Regulation Fair Disclosure Revisited*, (Dec. 2001), *available at* http://www.sec.gov/news/studies/regfdstudy.htm.
6. Richard H. Walker, Dir., Div. of Enforcement Sec. & Exch. Comm'n, Address to the Compliance & Legal Division of the Securities Industry Association: Regulation FD—An Enforcement Perspective (Nov. 1, 2000) (transcript available at http://www.sec.gov/news/speech.shtml) ("Let me be clear. We are not looking to frustrate the purpose of the rule—which is to promote broader and fairer disclosure of information to investors—by second-guessing reasonable disclosure decisions made in good faith, even if we don't agree with them. Nor are we looking to test the outer limits of the rule by bringing cases that aggressively challenge the choices issuers are entitled to make regarding the manner in which a disclosure is made. There will be no FD Swat teams, and I do not envision any FD sweeps, unless, of course, there is widespread noncompliance with the rule, which I do not anticipate… . At the same time, however, you should understand that the Enforcement Division is not a toothless tiger. We expect issuers and others to conform their conduct to the requirements of the rule, and if they don't, we will take steps to make them do so.").
7. *In re Secure Computing Co.*, Exchange Act Release No. 46,895 (Nov. 25, 2002); *In re Siebel Sys., Inc.*, Exchange Act Release No. 46,896 (Nov. 25, 2002); *In re Raytheon Co.,* Exchange Act Release No. 46,897 (Nov. 25 2002); *Section 21(a) Report of Investigation: Motorola, Inc.*, Exchange Act Release No. 46,898 (Nov. 25, 2002).

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8. *§ 21(a) Report of Investigation: Motorola, Inc.*, Exchange Act Release No. 46,898, nn.12-13 (Nov. 25, 2002).
9. *SEC v. Schering-Plough Co.*, Exchange Act Release No. 48,461 (Sept. 9, 2003).
10. Full disclosure: my law firm was counsel for Siebel in the successful defense of this case.
11. *SEC v. Siebel Sys., Inc.*, Litigation Release No. 18,766 (Jun. 29, 2004). See *S.E.C. v. Siebel Systems, Inc.*, 384 F. Supp. 2d 694, 697, Fed. Sec. L. Rep. (CCH) P 93343 (S.D. N.Y. 2005)("The SEC alleges that, at these two events, [the CFO] privately disclosed material nonpublic information by stating that Siebel Systems's activity levels were 'good' or 'better,' that new deals were coming back into the pipeline, that the pipeline was 'building' and 'growing,' and that 'there were some $5 million deals in Siebel's pipeline.' …The SEC claims that these statements materially contrasted with public statements made by [the CEO] during conference calls on April 4th and 23rd, and at an April 28th conference.").
12. *S.E.C. v. Siebel Systems, Inc.*, 384 F. Supp. 2d 694, 704, Fed. Sec. L. Rep. (CCH) P 93343 (S.D. N.Y. 2005).
13. In *In re Flowserve Co.*, Litigation Release No. 19,154 (Mar. 24, 2005), the SEC alleged that Flowserve's CEO and its Director of Investment Relations had met privately with analysts from brokerage firms and given them non-public earnings guidance for the year. In *SEC v. Black*, Litigation Release No. 21,222 (Sept. 24, 2009), the SEC alleged that the CFO sent an e-mail to the eight sell-side analysts who covered the company stating that EPS for the second quarter "will likely be in the neighborhood of about a dime below that of the first quarter," effectively cutting second-quarter guidance in half.

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