

The SEC's New Selective Disclosure Rules – What Does It All Mean?

By now you have no doubt seen a number of news articles about the Securities and Exchange Commission's adoption of a new Regulation FD which went into effect on October 23, 2000. Back in August we sent to our public clients a letter briefly outlining the basic scope of the new regulation. Now that Regulation FD has gone into effect and people have begun to grapple with the problems which it creates, it is possible to talk a little more about the practical implications of the new regime.

WHAT'S ALL THE FUSS ABOUT?

Over the last ten years, the country has lived through an unprecedented bull market, and the number of investors who are directly investing in the stock market increased dramatically. At the same time, the advent of the internet has made information (including financial information) far more available to both professional investors and

individual investors than ever before. The SEC, and particularly its Chairman, Arthur Levitt, have become increasingly concerned about practices which have developed over the last ten years of selective disclosure by public companies of material non-public information such as advance warnings of earnings results, guidance on anticipated results, or other information to market professionals, particularly to the investment analysts at the large brokerage firms which provide analyst coverage for, and act as market makers of the stock of, public companies. The SEC has become more sensitive to some of the subtle dangers which may arise in an environment in which companies (particularly those which are smaller, growth-oriented companies) have become highly dependent upon favorable coverage from a few analysts. The SEC is concerned that during a period of unprecedented access to information and unprecedented participation in the capital markets, selective disclosure could lead to a loss of

confidence by individual investors in the integrity of the capital markets due to the information advantage enjoyed by the privileged few.

In an attempt to respond to that problem, the SEC has adopted Regulation FD to clarify the rules of the road for company officials in dealing with analysts and other investment professionals.

WHAT DOES REGULATION FD DO?

Regulation FD (which stands for Full Disclosure) requires that when senior officials of public companies intentionally disclose material non-public information to market professionals, they must simultaneously disclose the same information to the general public. It further requires that when these senior officials unintentionally disclose material non-public information to market professionals, they must promptly thereafter make the same infor-

mation available to the general public.

The basic point to remember about Regulation FD is it governs interactions between a specified subset of company officials (in essence, those persons whom analysts and the investing public would think of as speaking for the company on financial and strategic matters) and a subset of the investing public (primarily market professionals) with respect to disclosure of information which is both material and non-public.

What Is Material Nonpublic Information?

While the SEC's release lists a number of items of information which should be reviewed carefully to determine whether they are material (such as earnings information, mergers, changes in control or management, changes in auditors, etc.), Regulation FD does *not* change the old rules as to what constitutes material information. Information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making a decision whether to buy or sell the company's stock, or if it would have "significantly altered the total mix of information available." Determining when a particular matter is material remains an

often difficult judgment. Information is public if it has been disseminated in a manner reasonably designed to make it available to investors generally; otherwise it is non-public.

Who Are The Senior Officials To Whom Regulation FD Applies?

Regulation FD defines "senior officials" to mean any director, executive officer, investor relations or public relations officer, or other person with similar functions. Statements made by rank and file employees of the company generally will not trigger the disclosure obligations of Regulation FD, unless the employee is making the statement at the direction of a senior official.

Who Are The Market Professionals To Whom Regulation FD Applies?

Market professionals are generally:

- brokers, dealers and persons associated with them, such as securities analysts;
- investment advisers, institutional investment managers and persons associated or affiliated with them;
- investment companies, hedge funds or their affiliates;

- stockholders, where it is reasonably foreseeable that the stockholder will buy or sell the company's securities on the basis of that information.

Specially excluded from the subset of people to whom disclosures are covered by Regulation FD are:

- persons owing a duty of trust or confidence to the company (such as attorneys, investment bankers and accountants);
- persons who expressly agree to keep the information confidential;
- rating agencies, provided the information is disclosed solely for the purpose of developing a credit rating and the entity's ratings are publicly available;
- persons who receive the disclosure in connection with a registered public offering (this permits the typical "road show presentation" in connection with a registered offering);
- members of the media;
- customers, suppliers, and strategic partners with respect to the ordinary course of business; and
- government regulators.

When Are Disclosures "Intentional"?

A selective disclosure of material nonpublic information is

considered to be “intentional” when the person making the disclosure either knows, or is reckless in not knowing, that the information he or she is communicating is *both* material and non-public. If the senior official had not planned to disclose information he or she knows to be material and nonpublic, but during the course of a non-public discussion with an analyst, decides to provide that information, then the disclosure would be considered intentional. Public disclosure must be made *simultaneously* with an “intentional” disclosure.

Any disclosure which is not intentional is considered unintentional. If there is an unintentional disclosure the company must disclose the information as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day’s trading). The time period is measured from when a senior official of the company learns of the disclosure and knows (or is reckless in not knowing) that the information disclosed was *both* material and nonpublic.

How Can I Show Public Disclosure?

According to Regulation FD, the company can make public disclosure in either of two ways:

- The company may file the information with the SEC on a Form 8-K, or some other appropriate SEC reporting form. Disclosing the information in a document publicly filed on EDGAR with the SEC within the timeframe of Regulation FD would always constitute public disclosure, although the SEC does caution against burying the disclosure in a larger SEC filing. If the company chooses to file with the SEC, it may elect either to “file” the information under Item 5 of Form 8-K (which would subject the company to liability under the Securities Exchange Act of 1934 for false reports and would also automatically incorporate the information by reference into the company’s current registration statements under the Securities Act of 1933 on Form S-3, S-8, etc.) or to “furnish” the information under Item 9 of Form 8-K (which would not create that liability or cause incorporation into the registration statements). In either case, however, the disclosure would remain subject to the antifraud provisions of the federal securities laws.

- The company may disseminate the information through a method (or combination) reasonably designed to provide broad, non-exclusionary dis-

tribution of the information to the public. This may be accomplished by (i) issuing a press release distributed through a widely circulated news or wire service such as Dow Jones, Business Wire, Reuters, Bloomberg or PR Newswire, (ii) making an announcement through a press conference or conference call with adequate advance notice to the public so that interested members of the public may participate in the call, or (iii) by other electronic transmission, including use of the Internet and webcasts. However, merely posting the information on the company’s website will generally not be considered to be a sufficient means of public disclosure. Likewise, for those companies whose press releases are not routinely carried by major news wire services, it may not be sufficient for the company to make public disclosure solely by submitting its press release to one of its wire services. Again, the disclosure would be subject to the antifraud provisions of federal securities laws.

What Happens If We Violate Regulation FD?

To remedy violations of Regulation FD, the SEC may impose

civil monetary penalties, issue cease and desist orders and/or seek injunctive relief. There is no right of action for a private lawsuit under Regulation FD solely from a company's failure to comply with Regulation FD. However, if there exist independent grounds for liability (for example under Rule 10b-5 for tipping, insider trading, a duty to correct or update or entanglement, among others), then a private suit can be brought. The company's failure to comply with Regulation FD will not result in the loss of eligibility to use short-form registration statements, the loss of the safe harbor provisions for forward looking statements, or affect stockholders' ability to resell their securities under Rule 144.

SOME PRACTICAL GUIDANCE FOR LIVING WITH REGULATION FD

It is abundantly clear that public companies will face new challenges in the way they disclose information under Regulation FD. Of particular interest is the following SEC statement in adopting the new rule:

“One common situation that raises special concerns about selective disclosure has been the practice of securities analysts

seeking “guidance” from issuers regarding earnings forecasts. When an issuer official engages in a private discussion with an analyst who is seeking guidance about earnings estimates, he or she takes on a high degree of risk under Regulation FD. If the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated earnings will be higher than, lower than, or even the same as what analysts have been forecasting, *the issuer likely will have violated Regulation FD. This is true whether the information about earnings is communicated expressly or through indirect “guidance,” the meaning of which is apparent though implied. Similarly, an issuer cannot render material information immaterial simply by breaking it into ostensibly non-material pieces.*

“At the same time, an issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a “mosaic” of information that, taken together, is material. Similarly, since materiality is an objective test keyed to the reasonable investor, Regulation FD will not be implicated where an issuer discloses immaterial information whose significance is discerned by the analyst. Analysts can provide a valuable service in shifting through and extracting information that would not be

significant to the ordinary investor to reach material conclusions. We do not intend, by Regulation FD, to discourage this sort of activity. The focus of Regulation FD is on whether the issuer discloses material nonpublic information, not on whether the analyst, through some combination of persistence, knowledge, and insight, regards as material information whose significance is not apparent to the reasonable investor.” [emphasis added].

What is apparent from the above statement is that most companies will now need to be more cautious about the manner in which they disclose material nonpublic information, particularly their earning estimates, so as not to violate Regulation FD.

How Do We Handle The Quarterly Earnings Release Or Other Scheduled Announcement?

One of the few positive aspects of Regulation FD is that it did expressly sanction a process with respect to quarterly earnings releases which substantially follows the previous “best practices”:

“We believe that issuers could use the following mode, which employs a combination of methods of disclosure, for making a planned disclosure of material

information, such as a scheduled earnings release:

- **First, issue a press release, distributed through regular channels, containing the information;**
- **Second, provide adequate notice, by a press release and/or website posting of a scheduled conference call to discuss the announced results, giving investors both the time and date of the conference call, and instructions on how to access the call; and**
- **Third, hold the conference call in an open manner, permitting investors to listen in either by telephonic means or through Internet web-casting.**

By following these steps, an issuer can use the press release to provide the initial broad distribution of the information, and then discuss its release with analysts in the subsequent conference call, without fear that if it should disclose additional material details related to the original disclosure it will be engaging in a selective disclosure of material information.” [emphasis added].

The highlighted language is quite important. As long as the company gives adequate notice of a conference call open to the public and describes the basic subject matter of that call, anything said about that subject matter during that conference is

deemed to have been publicly disclosed, and the company will not have violated Regulation FD, even if during the course of the conference call significant additional detail which is material is disclosed.

What Is Adequate Notice?

Adequate advance notice should include the date, time and call-in information so that interested parties have a reasonable means of participating, and should be disseminated “within a reasonable time period” ahead of the conference call. It should also include any information as to the rebroadcast of the call. In response to questions, the SEC has suggested that “several days” normally would be enough advance warning of the time of the quarterly earnings conference call. As a practical matter, since the earnings release itself often proceeds the analyst call by 18 hours or less, this means that to get the benefit of this “safe harbor procedure”, companies will need to first issue a press release (or otherwise satisfy the broad dissemination rules above) simply announcing the upcoming earnings release and conference call, with the appropriate call-in information, then put out the actual earnings release repeating this information before the analyst conference call.

In the case of an unexpected development (such as a merger announcement or an earnings warning) the SEC does admit that a shorter amount of advance notice may be sufficient.

How Will Regulation FD Impact Relations With Analysts?

The issue that has caused the greatest concern under Regulation FD is the SEC’s statement quoted above about private conversations with analysts, particularly the comment that even simple confirmation to an analyst that the company is still comfortable with the street estimates or its own projections creates a substantial risk of violation of Regulation FD. This new regime may have several consequences.

One consequence is that some companies, primarily large, widely-followed companies, may simply stop talking to analysts one-on-one. This may not be practical, however, for other companies.

One of the consequences we are already seeing is that the analysts’ conference calls are becoming much longer because analysts feel forced to ask all of their questions (even questions on minor details) in the confer-

ence call for fear that if they do not, they may not be able to get the company to answer the question privately later. Another is that if company management does not know the answer to the question asked during the call, instead of simply promising to get back to that analyst directly afterward with the answer, it now must assess whether the answer might be later judged material, and whether to file a Form 8-K containing the answer.

If the process becomes truly unwieldy, analysts may be forced to reduce the number of companies they provide coverage on, creating the risk that smaller companies will lose coverage.

This new regime also may force many companies to seriously assess whether it is necessary to begin publishing their own revenue and earnings projections on a regular basis in order to lay a foundation permitting one-on-one discussions with analysts to take place where the analysts can ask for additional details about the assumptions and details forming the basis for the projections (the information which allows the analyst to complete his “mosaic” of information?) but which do not change the basic conclusion.

Other companies may feel compelled to provide initial guidance concerning the next quarter’s results in their earnings releases (which typically are issued 20 to 30 days after quarter-end) and then update that guidance in the MD&A section of the Form 10-Q filed 45 days after quarter-end. Since many companies already have policies prohibiting any discussions in the nature of guidance during the quarterly “black-out period” (typically from 30 days prior to quarter-end until issuance of the earnings release), this will leave a relatively short period after the Form 10-Q filing date and before the blackout period begins. Any discussions during that period may be sufficiently close in time to the guidance given in the Form 10-Q so that a simple confirmation that the company is still comfortable with the Form 10-Q forward-looking information arguably is not material. However, if the company believes that the previous guidance is no longer accurate, it could not update its guidance on a selective basis, no matter how close in time to the previous guidance.

Another possible approach is to require the analyst, prior to answering a question which might involve material non-public in-

formation, to agree to a 24 hour embargo prior to communicating the information to anyone else, in order to give the company time to determine whether the information is in fact both material and non-public, and to arrange public dissemination of the information if required.

Finally, companies should continue to avoid conversations during their quarter-end blackout periods.

What About Commenting On Analysts’ Draft Reports?

One of the most difficult issues is the common practice of company officers reviewing analysts’ reports in draft form. The safest course is, of course, not to do so at all. However, that often may not be practical. If the company feels it must accept an analyst’s offer to let it review the draft, it must recognize that there is risk in doing so. In addition, the company officer should limit his or her comments on the analysts’ earning models or draft reports to correcting errors of historical fact and pointing out information that is in the public domain. He should not opine on the analyst’s model or conclusions, or use the discussion as a vehicle for selectively communicating material non-public information.

Can We Still Present At Investor Conferences?

A company should be sure that any broker-sponsored investor conferences at which it presents are web simulcast with a prior press release telling interested parties how they can listen in, or otherwise are conducted in a way that will satisfy the public dissemination rules discussed above, or else the company must scrub its presentation and its answers in the Q&A sessions to limit itself to information which has previously been publicly disclosed. Even if the formal presentations are accessible to the public, particular care needs to be taken to be sure that no material non-public information be given out at any follow-on “one-on-one” discussion or “break-out session” which is not open to the public. In addition, to the extent that material non-public information may appear on power point or similar presentation materials advance planning needs to be done as to how that information can be publicly disseminated, including practical issues like the mechanical problems of EDGARizing slides for filing with a Form 8-K.

What Else?—Should We Establish Procedures Now?

We recommend that each public company review its existing disclosure policies, or if it has not already done so, adopt written disclosure policies, which are consistent with the requirements of Regulation FD. Such policies should address the following issues:

- Limitations on who (by name and position) is authorized to speak with analysts, market professionals and investors on behalf of the company.
- Whether or not to require that more than one company official participate, or that an investor relations officer participate, in all conversations with analysts, market professionals and investors—this may not be practical for smaller and mid-sized public companies
- Clear guidelines on the permitted scope of communication during private sessions with analysts, market professionals and investors.
- A procedure for company officials, legal counsel and investor relations officers to clear and/or review any questions as to the materiality of information.

- Specific procedures to follow when senior officials learn that an unintentional disclosure of material nonpublic information may have occurred, including the procedures for review by counsel and management for a determination and an outline of how to promptly disclose that information.
- Guidelines for reviewing (or not reviewing) drafts of analyst reports or models.
- Formal adoption of a blackout period on discussions with analysts from the beginning of the last month of the quarter until the earnings release if the company has not already done so.
- Procedures on issuing earnings reports or forward-looking earnings estimates.
- Guidelines on participation in investor conferences, trade shows, etc., including obtaining assurances from sponsors as to how they will be made accessible to the public.
- Procedures on dealing with power point presentations, handouts, etc. which may contain material non-public information disseminated at any meeting with market professionals or investors—getting them filed with the SEC and dealing with issues created by the fact that different rules can

apply to forward-looking written statements.

- A procedure to make all analyst conference calls available for re-broadcast for a specified period of time. We recommend that they remain accessible for listening for no more than three or four days, and that they not be downloadable or printable, since that turns them into written statements, with different legal rules concerning forward-looking statements.
- A policy of consistently reading the appropriate dis-

claimer for any forward-looking statements at the beginning of all oral presentations of information.

CONCLUSIONS

The full impact of Regulation FD is far from clear. There undoubtedly will be a period of uncertainty as public companies, analysts and other struggle to work out practical ways of dealing with these new rules. We urge every public company to work together with its legal

counsel and investor relations professional to understand the full scope of Regulation FD and how it may affect your company's particular practice.

Brown, Rudnick, Freed & Gesmer is prepared to assist you and your company in understanding and complying with Regulation FD and/or developing appropriate disclosure policies. For further information, or if you should have any questions or comments regarding Regulation FD, please do not hesitate to contact one of us.

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