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Corporate and Securities Law Developments

COMMISSION ISSUES PROPOSED RULES ON SELECTIVE DISCLOSURE AND INSIDER TRADING

On December 20, 1999, the Securities and Exchange Commission promulgated three proposed rules intended to prevent selective disclosure by issuers of material, non-public information and to clarify two "unsettled issues" of insider trading law: i) the "use/possession" standard in response to recent adverse judicial rulings and ii) circumstances in which a family or other non-business relationship may form the basis of a misappropriation of material, non-public information.[1/]

Comments on all three proposed rules are due on or before 90 days after their publication in the Federal Register.

I. Selective Disclosure - Proposed Regulation FD

Calling selective disclosure by issuers of material, non-public information to analysts and institutional investors a "stain on our markets," troubled by the impact selective disclosures can have on the market price of the issuer's securities, and worried that selective disclosure may promote opportunities for analyst conflicts of interest, Chairman Levitt made clear at an open meeting of the Commission on December 15, 1999 that the Commission is determined to put a stop to it. The Commission's proposal is Regulation FD ("Fair Disclosure") under the Securities Exchange Act of 1934. Significantly, the proposed rule's imposition of duties and liabilities is limited to issuers, and the rule would take selective disclosure outside the ambit of insider trading law and the private rights of action flowing from possible violations of the anti-fraud provisions.

Regulation FD would impose two basic requirements on issuers:

- any *intentional* disclosure of material, non-public information *by an issuer* or any person acting on its behalf must be made in a public forum or public communication simultaneously with disclosure to any other person or entity;

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[1/] *See* Exchange Act Release No. 42259, Securities Act Release No. 33-7787, IC Release No. 24209 (Dec. 20, 1999) ("Release"). The release may be found at <http://www.sec.gov/rules/proposed/34-42259.htm>.

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- if an issuer learns that it *unintentionally* has made a selective disclosure of material, non-public information, it must make "prompt public disclosure of that information."[2] "Prompt" means as soon as reasonably practicable but in no case more than 24 hours after discovery of the inadvertent disclosure.

The Regulation as proposed would apply to all issuers with securities registered pursuant to Section 12 of the Exchange Act and to those issuers required to file reports under Section 15(d) of the Act, including closed-end investment companies (but not including other investment companies). With respect to a "person acting on behalf of an issuer," that term would be defined as any officer, director, employee, or agent of the issuer who discloses material non-public information while acting within the scope of his or her authority. This definition is intended to insulate the issuer itself from liability under the proposed Regulation when one of its employees or agents improperly trades or tips or when the information is disclosed by such an agent or employee to another who owes that agent or employee a duty of trust or confidence.

The proposed regulation does not purport to change the "materiality" standard under the federal securities laws.[3] Mindful of the "potential burdens of requiring instant materiality judgments to be made by those put in the position of responding immediately to questions,"[4] the Commission suggests that such concerns can be mitigated in several ways:

- Designating a limited number of persons authorized to make disclosures or field inquiries;
- Keeping a record of the substance of private communications with analysts or selected investors;
- Declining to answer questions that raise issues of materiality before consulting with others; and
- Securing the agreement of analysts not to use certain information for a limited time until the issuer has had the opportunity to review notes of the conversation and to consult with others.

The Commission has acknowledged the concern of the securities industry that the proposed rule could have a chilling effect on the dissemination of information to analysts and the financial press. Given the proposed rule's breadth, the rule could be violated by a speech, by a telephone call, by a fax to investor relations firms or

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[2] *See* Release pt. I (emphasis added). Calling Regulation FD an "issuer disclosure rule," the Commission states that its authority to promulgate the Regulation is primarily seated in Section 13(a) of the Exchange Act, comparing the Regulation to existing disclosure rules under Exchange Act Sections 13(a) and 15(d). *Id.* pt. II.A.

[3] The objective standard on materiality is set forth in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

[4] *See* Release pt. II.B.2.

financial publications or by virtually any form of communication deemed to be less than fully-public. At the public meeting on December 15, General Counsel Goldschmid said that the chilling effect would be minimized by several safeguards:

- The proposed rule is not an anti-fraud provision, and there would be no private right of action under it. The rule's enforcement would lie solely with the SEC's Division of Enforcement.[5/]

- The proposed rule would be limited to intentional selective disclosures, although a company discovering an inadvertent selective disclosure would have to move promptly to make full public disclosure.

- Issuers would still be able to make confidential selective disclosures so long as such disclosures were subject to a confidentiality agreement.

- Issuers would have some flexibility in determining how they would make public disclosures. The proposed Regulation would require public disclosure through the filing of a Form 8-K (or 6-K in the case of a foreign private issuer), a press release through a widely circulated news or wire service, or "any other method of disclosure that is reasonably designed to provide broad public access to the information and does not exclude any members of the public from access, such as announcement at a press conference to which the public is granted access" (personally or telephonically).[6/] Merely posting the information on the Internet would not satisfy the public disclosure requirement.[7/]

Although the proposed rule purports to take issuer liability for intentional selective disclosures outside the ambit of traditional insider trading laws, it is unclear whether and to what extent recipients of information (such as broker/dealers and analysts) can generally rely on the rule to govern the actions of issuers.[8/] For example, if information is disseminated on an issuer's conference call with analysts, it is unclear whether the analysts may assume that the information has been previously or simultaneously distributed to the public and that they are not

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5/ The Release notes that the Commission could bring an administrative action seeking a cease and desist order, or a civil action seeking an injunction and/or civil monetary penalties. The Commission's intention in this regard would not prevent the Division of Enforcement from recommending the institution of an insider trading case if the Division believed that the circumstances of the selective disclosure gave rise to both a violation of Regulation FD and Section 10(b) violations under traditional insider trading liability, "duty to correct" or "duty to update" liability, or liability under the "entanglement" or "adoption" theories. *See* Release pt. II.B.7. The Commission notes in its release, however, that one of its reasons for promulgating Regulation FD was the increased difficulty of prosecuting selective disclosure under traditional insider trading principles in the wake of the Supreme Court's decision in *Dirks v. SEC*, 463 U.S. 646 (1983). *Id*. pt. II.A.

6/ *See* Release pt. IX.

7/ *Id*. pt. II.B.5.

8/ The Release does note that, in appropriate circumstances, the Commission could bring an enforcement action against the individuals at the issuer responsible for the violation either as a "cause of" the violation in an administrative proceeding or as an aider and abettor in a civil injunctive action. *See* Release pt. II.B.7.

the recipients of selective disclosures. The rule is also silent on what liabilities those recipients might risk if they, in turn, disclosed the information to their trading desks or customers.[9]

Because the proposed Regulation applies only to issuers that have registered securities under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of the Act, the Regulation would not apply during an issuers initial public offering before the registration statement became effective. The proposed Regulation, would, however, apply to disclosures made by reporting issuers while they have pending registration statements for offerings. Thus, if an issuer made an oral selective disclosure during a road show, the proposed Regulation would require simultaneous public disclosure of the same information, a notable departure from the current distinction between oral and written communications around the time of an offering.

The Release notes that the public disclosure required by the proposed Regulation could be considered an "offer" under Section 5 of the Securities Act and, when made in writing or broadcast, could be considered a "prospectus" under Section 2(a)(10) of the Act, raising the possibility that an issuer could violate Sections 5(c) or 5(b)(1) of the Act by making the disclosure required by the Proposed regulation. To mitigate the effect of such a possibility, the Commission is proposing new Rule 181 under the Securities Act. Under this proposed Rule, any intentional disclosure required by proposed Regulation FD would not be required to satisfy the requirements of Section 10 of the Securities Act for a prospectus, as long as the disclosure requirements of Regulation FD were satisfied.

The Commission is not inclined, however, to adopt an exemption from Section 5(c) of the Securities Act governing "offers," fearing that issuers might abuse the exemption to hype an offering before filing a registration statement.

Finally, the proposed Regulation would impose requirements on material communications, whether written or oral, that are in addition to the filing and legend requirements of the new business combination rules.[10] The Release notes that issuers may use confidentiality agreements to protect communications made in the context of business combinations or other transactions not intended for public disclosure. Early discussions among parties to a proposed transaction, or discussions between a party to a transaction and a security holder regarding a possible "lock up," that were subject to a confidentiality agreement, would not be subject to the proposed Regulations disclosure requirements.

II. Clarification of the "Use/Possession" Standard in Insider Trading Cases - Proposed Rule 10b-5-1

It has long been the Commission's position that a person is liable for insider trading under Section 10(b)

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[9] The Release makes clear, however, that the proposed Regulation would not apply to "temporary insiders" and others whose position of trust and confidence could expose them to insider trading theory under the misappropriation theory. *See* the discussion of proposed Rule 10b-55-2 *infra*.

[10] *See* Regulation of Takeovers and Security Holder Communications, Securities Act Release No. 7760 (Oct. 22, 1999), 64 Fed. Reg. 61408 (Nov. 10, 1999) (effective date Jan. 24, 2000).

and Rule 10b-5 of the Exchange Act when such person "possessed" material non-public information about a company and purchases or sells the stock. Two appellate courts, however, rejected that standard, finding that the element of *scienter* in a Section 10(b) case required proof of fraudulent intent, and that the fraudulent intent could not be established unless it was shown that the insider actually *used* the information in the trading decision (emphasis added).

In *SEC v. Adler*,[11/] the Eleventh Circuit held that the SEC had to provide evidence sufficient for a finder of fact to determine that the insider actually "used" the information when he traded, or, put another way, that the insider's knowledge of the inside information was a substantial factor in his decision to trade at a particular time or at a particular price.[12/] The *Adler* Court reasoned that mere knowing possession of inside information at the time of trading established a "strong inference" of use, but one that the insider can rebut by showing that he had independent, legitimate reasons for trading when he did.[13/]

The Ninth Circuit adopted the reasoning of *Adler* in a criminal securities fraud case, *United States v. Smith*.[14/] On appeal from his conviction, Smith challenged a jury instruction that purportedly stated he could be found guilty on the basis of "knowing possession" of material non-public information, arguing that the government was required to show that he actually used the information.[15/] The Court agreed, relying heavily on *Adler*, but declined, for constitutional reasons, to apply, in a criminal setting, the rebuttable presumption of use to which "knowing possession" gave rise.[16/]

In response to the *Adler* and *Smith* decisions, the Commission has promulgated proposed Rule 10b-5-1, which states that liability for trading on the basis of material non-public information will arise when a person trades while "aware" of such information. Embracing the rebuttable presumption aspects of the *Adler* decision, the rule sets forth several affirmative defenses that will permit the defendant to avoid liability by showing that the trade resulted from

- a pre-existing binding contract to purchase the security in the amount, at the price, and on the date which the person so purchased or sold;

- a prior instruction to another person to execute a purchase or sale in the amount, at the price,

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11/ 137 F.3d 1325 (11th Cir. 1998).

12/ *Id*. at 1337.

13/ *Id*.

14/ 155 F.3d 1051 (9th Cir. 1998).

15/ *Id*. at 1066.

16/ *Id*. at 1067-69. The Ninth Circuit ultimately upheld the conviction, however, finding that because the trial court had instructed the jury that the government must prove that Smith's knowledge of insider information was a significant factor in his decision to trade, and that knowing possession by itself was not sufficient to sustain a conviction, the Court found that Smith "has nothing to complain about" even under the more rigorous "use" standard. *Id.* at 1070.

and on the date which the purchase or sale was executed;

- a previously adopted or adhered to written plan specifying purchases or sales in the amounts, at the prices, and on the dates at which the purchases or sales occurred; or

- a previously adopted or adhered to written plan for trading designed to track or correspond to a market index, market segment, or group of securities, and the amounts, prices, and timing of the purchases actually made were the result of following the plan.[17]

The defendant must be able to demonstrate that any such contract or plan was entered into in good faith and not to evade the prohibitions of the proposed Rule. The proposed rule also specifies that the affirmative defense will be lost if the defendant enters into or alters a corresponding or hedging transaction or position with respect to the planned securities trade. This second requirement is "designed to prevent persons from devising schemes to exploit inside information by setting up pre-existing hedged trading programs, and then canceling execution of the unfavorable side of the hedge."[18]

At the December 15, 1999 public meeting, SEC General Counsel Goldschmid said that the proposed rule was intended to follow *Adler* by establishing a rebuttable presumption of intended use. In response to a question from Commissioner Unger, Goldschmid predicted that the courts deciding *Adler* and *Smith* would defer to the Commission's rulemaking, adding that he did not anticipate other judicial challenges.

Such a prediction may be overly optimistic. It remains to be seen precisely how broadly courts will construe the affirmative defenses. For example, does a "pre-existing plan" include a previously-designed and implemented trading strategy? It also remains to be seen what level of evidence that the SEC will argue satisfies the proposed "aware of" standard or what level of proof courts will accept as sufficient to give rise to a rebuttable presumption of intended use. It is not clear whether documentation will be the touchstone for such proof. It is also not clear whether the Commission's promulgation of the rule falls within its statutory rulemaking authority. While the Commission, as an administrative agency, has the power to interpret and modify its own rules, it remains an open question whether the courts will view an effort to define fraud as encroaching on the province of Congress.

III. The Misappropriation Theory and Confidential Non-Business Relationships - Proposed Rule 10b-5-2

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[17] *See* Release pt. III.A.2. The proposed Rule would provide an additional separate affirmative defense solely for entities that trade, derived from the defense against liability currently provided in Exchange Act Rule 14e-3(b) regarding insider trading in tender offer situations. To raise the defense successfully, the entity will have to demonstrate that i) the individual(s) making the decision on behalf of the entity was not aware of the information and ii) the entity had implemented reasonable policies and procedures to prevent insider trading. *Id*.

[18] *Id.*

Under the "misappropriation theory" of insider trading, upheld in *United States v. O'Hagan*,[19] a person may be found liable for trading on material, non-public information that the trader misappropriated from another in breach of a confidential relationship.[20] While Courts have had an easier time finding the existence of such confidential relationships in established business relationships,[21] the law is less clear as to whether the misappropriation theory can be applied to confidential relationships in non-business settings, such as familial or other personal relationships.[22]

Purporting to clarify and strengthen the law in the area of non-business relationships, the Commission has promulgated proposed Rule 10b-5-2. Under this proposed rule, a person who receives confidential, material information would owe a duty of trust or confidence to the provider of such information and would, thus, be potentially liable under the misappropriation theory if the person then trades in the following circumstances:

- when the recipient explicitly agrees to keep the information confidential;
- when the persons involved in the communication had a history, pattern, or practice of sharing confidences that resulted in a reasonable expectation of confidentiality; or
- when the person who provided the information was a spouse, parent, child, or sibling of the recipient, unless it could be shown affirmatively, based on the facts and circumstances of that family relationship, that there was no reasonable expectation of confidentiality.

None of the Commissioners at the December 15, 1999 public meeting seemed enthusiastic about the proposed rule. Commissioner Johnson expressed the view that the SEC should not be in the business of prying into family relationships. SEC General Counsel Goldschmid responded that the Commission would not have to do so unless the defendant raised lack of confidential relationship as a defense. Nonetheless, the Commissioners view the proposed rule with some skepticism, suggesting that comments on the rule may be influential.

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We would be pleased to assist you in formulating comments to any of these proposed rules or in providing further information. Please contact Harry J. Weiss (202-663-6993), Thomas White (202-663-6224), Meredith Cross (202-663-6644), Yoon-Young Lee (202-663-6720), or Jeffrey E. McFadden (202-663-6385).

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[19] 521 U.S. 642 (1997).

[20] *Id*. at 652-53.

[21] *See, e.g.*, *United States v. Cusimano*, 123 F.3d 83 (2d Cir. 1997) (vice president of labor relations at AT&T misappropriated information belonging to AT&T); *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991).

[22] Compare *SEC v. Falbo*, 14 F. Supp. 2d 508 (S.D.N.Y. 1998) (information that trader acquired about tender offer from his spouse, who was executive assistant at tendering corporation, were obtained through breach of spouse's duty of confidentiality, as required by misappropriation theory) with *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (insufficient proof that husband and wife had sharing relationship of trust and confidence).

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