HOGAN & HARTSON L.L.P.
SEC UPDATE

NEW SEC RULE REGARDING "SELECTIVE DISCLOSURE"

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On August 10, 2000, the Securities and Exchange Commission adopted a new selective disclosure rule.[1] The new rule, called "Regulation FD," for "Fair Disclosure," is intended to address what the Commission sees as unfair disclosure by public companies of material non-public information to analysts, institutional investors, and other favored market professionals. Although the rule applies to selective disclosure of any material information, the Commission's primary focus seems to be on earnings forecasts and related information.

The new rule does not prohibit disclosure of information to analysts or anyone else. Instead, the rule requires companies to level the playing field between market professionals and individual investors by making material information available to all investors at the same time.

The rule, along with two new insider trading rules adopted at the same time, is discussed in detail below. The new rules become effective on October 23, 2000.[2]

OPERATION OF REGULATION FD

Company Officials Whose Disclosures are Subject to Regulation FD

Regulation FD applies only to disclosure of material non-public information by the company and persons acting on its behalf. "Persons acting on the company's behalf" means any senior official of the company, or any other officer, employee, or agent of the company who regularly communicates with market professionals or stockholders (for example, employees in the investor relations or public relations department).

Disclosures made by other employees or by third parties are not subject to the rule unless their communications are authorized or directed by senior officials. Disclosures by senior officials that are made in violation of a duty to the company (for example, material information "tipped" to a friend by an executive officer) are not subject to the rule (although such disclosures continue to expose the senior official to anti-fraud liability).

Prohibited Recipients of Selective Disclosure

Regulation FD applies only to disclosures made to:

- registered broker-dealers and their associated persons;
- registered investment advisors, institutional investment managers, and their associated persons;
- investment companies, hedge funds, and their associated persons; and
- holders of the company's securities, but only if it is reasonably foreseeable that the security holder will trade on the basis of the information disclosed.

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[1] Securities Act Release No. 33-7881, Exchange Act Release No. 34-43154, Investment Company Act Release No. 24599 (August 15, 2000) (the "Release"). The release is available on the SEC's internet website at http://www.sec.gov/rules/final/33-7881.htm.

[2] New Regulation FD applies to all domestic public companies and to closed-end investment companies. The rule does not apply to foreign companies, open-end investment companies (mutual funds), or non-public companies.

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Disclosures made to persons who fall outside of these categories (for example, the general press and similar media) are not subject to Regulation FD. In addition, even disclosures made to the prohibited class of market professionals are permissible if made to:

■ a person who owes a duty of trust or confidence to the company (*e.g.*, an attorney, investment banker, or accountant);

■ a rating agency, so long as the information is disclosed solely for the purpose of developing a credit rating and the agency's ratings are made public;

■ a person who expressly agrees (orally or in writing) to keep the information confidential; or

■ a person who receives the information in connection with a registered public offering (for example, during a roadshow presentation).

Types of Disclosures Covered

The rule applies only to disclosures of "material" information. The rule does not define "material," but instead offers examples of the types of information that might be deemed material (for example, earnings information, merger discussions, announcements of new customer relationships, and stock-related matters such as splits and dividend changes). Unfortunately, information sometimes seems "material" only in hindsight, after the market has reacted to the news. Accordingly, companies may be well-advised to err on the side of caution in making materiality judgments.

Timing of Public Disclosure

The primary purpose of Regulation FD is to ensure that material announcements reach all investors at the same time. The rule also recognizes, however, that disclosures made on a selective basis may, contrary to the company's initial conclusion, turn out to be material or to have been inadequately disseminated. The rule requires:

■ simultaneous communication to the public of "intentional" disclosures of material information to market professionals; and

■ "prompt" communication to the public of "non-intentional" disclosures once a senior official discovers the disclosure and realizes, or was reckless in not realizing, that the information was material and non-public. "Prompt" means disclosure within 24 hours or, if later, by the start of the next day's trading on the New York Stock Exchange.

A disclosure is "intentional" if the person making the disclosure knows, or is reckless in not knowing, that the information is both material and non-public. A selective disclosure is not "non-intentional" solely because the person making the disclosure did not plan to make the statement. If, for example, a senior official discloses information he or she knows is material and non-public in a "slip of the lip" response to a surprise question by an analyst during a private call, the disclosure will be deemed intentional. The universe of non-intentional disclosures is limited to errors in determining materiality or public availability of the information.

Manner of Public Disclosure

Regulation FD requires that the method or methods of public disclosure be "reasonably designed to provide broad, non-exclusionary distribution" of information to the public. Companies will have great flexibility in choosing methods that meet this requirement. Companies can disclose the information in a Form 8-K or use some other method, or combination of methods, designed for broad distribution.

For companies that choose not to file a Form 8-K, the SEC suggests a three-part disclosure model for planned events (such as earnings announcements):

■ issue a press release through channels that will provide broad dissemination;

■ provide broadly disseminated notice of the conference call, by press release and/or website posting, with instructions for public access; and

■ open the call to the public so all investors can listen, via telephone or internet webcasting.

Effect of Violations

A violation of Regulation FD will subject the company and its offending senior officials to a potential SEC enforcement action. The rule is not enforceable by investors or other private parties, nor does a violation necessarily constitute a violation of the anti-fraud provisions or other insider trading rules. Failure to file a Form 8-K, or filing one late, will not render the company ineligible to use Form S-2 or S-3 or to register employee benefit plan shares on Form S-8. Rule 144 also would remain available for resales of restricted and control securities.

RECOMMENDED ACTIONS

Companies should use the period between now and the effective date to analyze and adjust their disclosure programs to assure compliance with the new rule. Steps that companies should consider taking are set forth below.

1. Limit the Group of Persons Who Are Authorized to Talk With Analysts and Significant Stockholders

Regulation FD applies only to persons authorized to speak on behalf of the company. By authorizing a very limited number of persons to speak on behalf of the issuer to persons covered by Regulation FD, companies reduce their exposure to liability. Companies should keep a record of who is authorized to speak on behalf of the company and make clear to other employees that they are not so authorized.

2. Keep Records of Disclosure

Companies should brief authorized speakers on what matters have been publicly disclosed and make sure that, when in doubt, speakers avoid answering sensitive questions until they receive guidance from other officials or counsel. Companies also should keep a record of all communications with persons covered by Regulation FD.

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3. Be Cautious About Managing Analysts' Earnings Expectations

Companies naturally seek to monitor and manage the market's earnings expectations. Currently, many companies do so by reacting, in private or closed meetings, to analysts' earnings forecasts. Companies manage expectations by expressing "comfort" with a forecast or indicating that a forecast "seems high," "seems low," or is "within the range." The Commission has seriously challenged the propriety of responses of this type by saying, in the release adopting the new rule, that a senior official "takes on a high degree of risk under Regulation FD" when he or she "engages in a private discussion with an analyst who is seeking guidance about earnings estimates." The Commission warned that a statement to an analyst that the company's anticipated earnings will be "higher than, lower than, or even the same as what analysts have been forecasting" will likely constitute a violation of Regulation FD. Given the business imperative of keeping analysts' forecasts within a realistic range, companies may decide to engage in discussions with analysts about their earnings forecasts or earnings models only during calls or meetings to which the public is invited.

4. Select the Appropriate Means for Public Disclosure and Establish a Pattern of Disclosure for Both Routine and Unexpected Announcements

Companies must decide whether to make public disclosure using Form 8-K or another means of broad dissemination. Many companies will continue using press releases to publicly disclose material information, in part to satisfy the existing requirements of most exchanges and Nasdaq. For larger businesses, press releases are broadly disseminated as a matter of course. Companies that are not regularly followed by the investment community should take additional steps to distribute material information, such as contacting local media, using a press release service or filing a Form 8-K. Companies that choose to comply with Regulation FD by way of Form 8-K may "file" the form 8-K under Item 5 or instead "furnish" the information under Item 9. Information furnished under Item 9 will not be deemed incorporated by reference in the company's Forms S-3 and S-8.

Companies should pick whatever means of disclosure are appropriate and stick with them. It is important to establish an appropriate pattern of disclosure and avoid deviating from the routine except to address inadequate practices. The SEC has warned that a sudden change in disclosure practice may affect its judgment on whether a company acted reasonably in a given situation.

5. Open Analyst Calls to the Public

In addition to press releases, many companies communicate with the investment community through some form of analyst call. The SEC recommends that companies open these calls to the public using telephone and internet technology. One advantage of open access calls is that any new material information disclosed for the first time during the conference call is automatically disclosed in a way that satisfies Regulation FD. The public should be able to listen in real-time; posting only a replay of a conference call would not satisfy the "simultaneous" disclosure requirement. However, the issuer is free to structure the call/webcast so that the public can listen but cannot ask questions. The SEC suggests that a recording of the call be made available for persons who are not able to listen to the live feed.

6. Encourage Analysts to Ask Their Questions During Open Conference Calls, to Minimize Follow-Up Calls Seeking One-On-One Advice

By highlighting the value of open conference calls, the SEC clearly favors public forums for material disclosures. Some companies may avoid private meetings with analysts and institutional investors to the extent market forces permit. Others will continue to view one-on-one meetings and private sessions at investor conferences as useful ways to "fill in the gaps." Companies should be extremely careful during these meetings; new material information should never be disclosed in these settings. Companies should try to minimize the risk of inadvertent disclosure by encouraging analysts to ask their questions during open calls.

7. Monitor Marketplace Information About the Company

Most companies already keep tabs on information about the company circulating in the marketplace. By requiring "prompt" public disclosure of non-intentional disclosures after a senior official knew or should have known of the disclosure, Regulation FD creates added incentives for companies to keep track of the market. A company that monitors disseminated information, and the sometimes unexpected market reaction to such information, will be better placed to comply with the tight disclosure deadlines (as short as 24 hours) for non-intentional disclosures.

8. Obtain Confidentiality Agreements Where Appropriate

Regulation FD exempts disclosures to individuals who have promised to keep the information confidential. In particular, issuers planning unregistered offerings should make sure that all potential investors sign confidentiality agreements before they get access to material non-public information. Otherwise, the remedial public disclosure required by Regulation FD could violate the terms of the exemption from registration and endanger the deal.

9. If Comfort Is Given on Analysts' Earnings Estimates, Include in Form 10-K Meaningful Cautionary Statements and a Forward-Looking Statement Disclaimer, and Refer to Those Disclosures in Public Statements

Nothing in Regulation FD prevents companies from confirming analysts' estimates in a public setting. Remember that these confirmations are forward-looking statements that are subject to the safe harbor only if listeners are referred to company filings that contain meaningful cautionary language.

INSIDER TRADING RULES

The SEC also has adopted two new insider trading rules. The first rule addresses the "use versus possession" debate. Courts have split on whether insider trading liability requires proof that the insider used material non-public information in trading, or merely evidence that the insider knowingly possessed the information while trading. Rule 10b5-1 attempts to tip the balance in favor of a "use" standard. According to

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the rule, a person trades on the basis of material nonpublic information if the trader is "aware" of the material non-public information when making the trade, subject to certain exemptions. The second rule, Rule 10b5-2, clarifies the types of family and non-business relationships that give rise to a duty of trust or confidence that, if violated, could support a claim of insider trading under the "misappropriation" theory.

Rule 10b5-1 may have important implications for company insiders. Many insiders of active public companies are almost always aware of material non-public information. Without an exemption, they would never be able to trade. Rule 10b5-1 gives explicit protection from insider trading liability when company officials trade pursuant to a bona fide and previously established plan. The plan can provide for one-time or regular sales, but the insider cannot benefit from his or her knowledge of inside information. The plan must specify the price, amount and date of the trades or contain a written formula or algorithm to determine this information. The insider cannot have any subsequent influence over the trades. The SEC uses as an example of an appropriate plan, an insider's plan to exercise stock options and sell the shares one month before each date on which college tuition for a child is due, with the amount of the trade linked to the cost of tuition. Of course, the downside of such a plan is that trades must proceed regardless of market conditions.

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