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DISCLOSURE

A Refresher on Regulation FD and the SEC's Policing of Selective Disclosures

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Regulation FD (Fair Disclosure) is designed to preclude selective disclosures of material nonpublic information. In its release adopting Regulation FD, the Securities and Exchange Commission noted that those receiving material nonpublic information before the general public are ''able to make a profit or avoid a loss at the expense of those kept in the dark.'' Accordingly, Regulation FD provides that ''[w]henever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to [certain enumerated persons], the issuer shall make public disclosure of that information . . . (1) [s]imultaneously, in the case of an intentional disclosure; and (2) [p]romptly, in the case of a non-intentional disclosure.'' [17 C.F.R. § 243.100(a).]

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While there is no private right of action for violations of Regulation FD, the SEC has brought actions to enforce the Regulation. Relatively few such enforcement actions have been brought; nevertheless, Regulation FD has significantly altered the way issuers communicate with financial analysts, institutional investors, and shareholders. The article outlines the basic provisions of Regulation FD and discusses recurring themes in the Commission's enforcement actions.

Who is Covered by Regulation FD?

Regulation FD applies to both the issuer and ''any person acting on its behalf.'' As used in Regulation FD, the term ''issuer'' means a company that has a class of securities registered under Section 12 of the Securities Exchange Act of 1934 (the ''Exchange Act'') or that is required to file reports under Section 15(d) of the Exchange Act, including any closed-end investment company as defined in Section 5(a)(2) of the Investment Company Act of 1940. [17 C.F.R. 243.101(b) (noting, however, that the term ''issuer'' does not include ''any other investment company or any foreign government or foreign private issuer, as those terms are defined in Rule 405 under the Securities Act'').] The term ''person acting on behalf of an issuer'' includes (i) ''any senior official of the issuer (or, in the case of a closed-end investment company, a senior official of the issuer's investment adviser)''; and (ii) ''any other officer, employee, or agent of an issuer who regularly communicates with'' any of the securities market professionals enumerated in Rule 100(b)(1) of Regulation FD or with holders of the issuer's securities. [17 C.F.R. § 243.101(c).]

What Communications Can Trigger Regulation FD?

Rule 100(b)(1) of Regulation FD sets forth four categories of ''person[s] outside the issuer'' to whom selective disclosures are prohibited absent a specified exclusion:

- Brokers or dealers and their associated persons;
- Investment advisers, certain institutional investment managers, [Rule 100(b)(1)(ii) of Regulation FD includes an ''institutional investment manager,'' as defined in Section 13(f)(5) of the Exchange Act, that filed a report on Form 13F for the most recent quarter of the year. 17 C.F.R. § 243.100(b)(1)(ii).] and their associated persons;
- Investment companies, hedge funds, and their affiliated persons; and
- Any ''holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information.'' [17 C.F.R. § 243.100(b)(1)(iv).]

As noted in the Commission's release adopting Regulation FD, the above categories include ''sell-side analysts, many buy-side analysts, large institutional investment managers, and other market professionals who may be likely to trade on the basis of selectively disclosed information.''

What Communications are Exempt from Regulation FD?

Regulation FD carves out three categories of communications that do not trigger the public disclosure requirement. The prohibition on selective disclosures does not apply to disclosures made:

- To a ''temporary insider,'' that is, a ''person who owes a duty of trust or confidence to the issuer (such as an attorney, investment banker, or accountant)'';
- To a person who ''expressly agrees to maintain the disclosed information in confidence''; or
- In connection with a securities offering registered under the Securities Act of 1934 (the ''Securities Act''). [The exemption for offerings registered under the Securities Act does not apply to registered shelf offerings under Rule 415(a)(1)(i), (ii), (iii), (iv), (v), or (vi). This excluded group includes ''secondary offerings, dividend or interest reinvestment plans, employee benefit plans, the exercise of outstanding options, warrants or rights, the conversion of outstanding securities, pledges of securities as collateral and issuances of American depositary shares.'' *See* Adopting Release, at n.80.]

Issuers should note that communications with credit rating agencies are not exempt from Regulation FD. Such communications were exempted when Regulation FD was originally adopted, but this exemption was eliminated by Section 939B of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. [Pub. L. No. 111-203 (July 21, 2010).] Thus, it will often be advisable for an issuer to obtain an express nondisclosure agreement from a credit rating agency before communicating material nonpublic information to the agency.

When Must The Issuer Make a Disclosure to the Public?

Regulation FD does not compel issuers to disclose material nonpublic information to the general public. [Regulation FD does not define either of the terms ''material'' or ''nonpublic,'' relying instead on definitions developed in the relevant case law. Thus, information is material if ''there is a substantial likelihood that a reasonable shareholder would consider it important'' in making an investment decision, or there is a substantial likelihood that a fact ''would have been viewed by the reasonable investor as having significantly altered the ''total mix'' of information made available.'' *See* Adopting Release, at n.38-40 (citing relevant case law).] It says merely that if an issuer communicates such information to one of the enumerated persons covered by Regulation FD, then the issuer must also make a broad public disclosure of the information. The timing of the required disclosure depends upon whether the person acting on behalf of the issuer knew, or was reckless in not knowing, that the information he communicated was material and nonpublic.

Where a person who makes a disclosure on behalf of the issuer knows, or is reckless in not knowing, that the information disclosed is both material and nonpublic, the issuer must make a simultaneous public disclosure of the information. [17 C.F.R. § 243.100(a)(1).] On the other hand, where the person does not know at the time that the information is material and nonpublic, the issuer must ''promptly'' make a public disclosure of the information. [17 C.F.R. § 243.100(a)(2).] As used in Regulation FD, ''promptly'' means ''as soon as reasonably practicable'' after a senior official of the issuer learns that there has been an unintentional disclosure by the issuer of information that the senior official knows, or is reckless in not knowing, is both material and nonpublic. No public disclosure will be considered ''prompt,'' however, if it is made after the later of: (i) 24 hours after a senior official learns of the selective disclosure; or (ii) the commencement of the next day's trading on the New York Stock Exchange after a senior official learns of the selective disclosure. [17 C.F.R. § 243.101(d).]

What is ''Public Disclosure''?

Where Regulation FD requires a public disclosure, the issuer can satisfy that requirement by filing a Form 8-K with the Commission or by ''disseminat[ing] the information through another method (or combination of methods) . . . that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public.'' [Id. § 243.101(e).] The latter approach gives issuers flexibility, but also puts the onus on them to ensure that the method chosen is reasonable under the circumstances. For example, the Commission has said that if an issuer knows its press releases are not usually carried by major wire services, a press release would be insufficient. [Adopting Release.]

In practice, a key focus of the reasonableness determination appears to be whether the company has previously used a ''recognized channel of distribution.'' That is, whether the information is distributed through channels shareholders and the public expect. [*See* Commission Guidance on the Use of Company Websites, Exchange Act Release No. 58288, Investment Company Act Release No. 28351. (Aug. 7, 2008).] The Commission clarified this standard in a release regarding apparent violations of Regulation FD by Netflix, Inc. (''Netflix'') and its CEO Reed Hastings (''Hastings''). In July of 2012, Hastings made a post on his personal Facebook page congratulating Netflix employees for hitting a major viewership milestone. [Report of Investigation Pur-

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suant to Section 21(a) of the Sec. Exch. Act of 1934: Netflix, Inc. and Reed Hastings, Exchange Act Release No. 69279 (Apr. 2, 2013). Hastings congratulated Netflix's content licensing team for delivering one billion hours of content for June, the first time Netflix had reached that much viewership in a single month. *Id*.] At the time, Hastings's Facebook page had over 200,000 followers, including equity analysts, shareholders, bloggers, and reporters, but Netflix had never used Hastings's personal page to post company news or metrics and maintained its own website and Facebook page. [*Id*.]

Although the Commission ultimately chose not to bring enforcement proceedings against Netflix, it issued a ''Report of Investigation'' clarifying the applicability of Regulation FD to social media and implying that Netflix may have violated the Regulation. The Commission explained that while it encouraged companies to experiment with new forms of communication and engagement, including social media, these methods would not be reasonable public disclosures unless ''the company has made investors, the market, and the media aware of the channels of distribution it expects to use, so these parties know where to look for disclosures of material information about the company or what they need to do to be in a position to receive this information.'' [*Id*.] Thus, it appears that the Commission would not have a problem with an issuer making public disclosure via its website or social media so long as the public is aware that the company disseminates important investor information in that way. An ad hoc or surprise disclosure through a new medium, however, would probably not satisfy Regulation FD, even if it reaches a broad audience. The Commission also used the Netflix matter to remind issuers that Regulation FD's prohibitions ''do[] not turn on an intent or motive of favoritism,'' presumably meaning that Hastings's intent to congratulate his team, rather than to give company information to certain investors or analysts, is irrelevant. [*Id*.]

The Commission's Enforcement Efforts Have Focused on Selective Disclosure of Earnings Guidance

Since Regulation FD was adopted, the Commission has commenced only fourteen enforcement actions against issuers or individuals acting on their behalf. [Besides these enforcement actions, the Commission has also issued what it calls Reports of Investigation regarding apparent violations of Regulation FD. The Netflix report discussed above is one such example. Another important report dealt with a potential violation by Motorola, Inc. (''Motorola''). *See* Report of Investigation Pursuant to Section 21(a) of the Sec. Exch. Act of 1934: Motorola, Inc., Exchange Act Release No. 46898 (Nov. 25, 2002). There, the Commission issued a Report rather than bringing an enforcement action against Motorola or its senior officials because, prior to making the selective disclosure, Motorola officials sought the advice of in-house legal counsel, who determined that the information to be disclosed was neither material nor nonpublic. The Commission disagreed with Motorola's counsel, but determined that counsel's advice was given in good faith. The Commission cautioned, however, that ''having now issued this Report, we would be less likely in future cases to credit reliance on counsel for the advice rendered here.'' *Id*.] The majority of these enforcement actions have concerned an issuer's selective disclosure of information regarding financial performance and earnings guidance to analysts or other financial market professionals, though disclosure of other types of material nonpublic information have also prompted enforcement actions. [*See, e.g.*, *In re Lawrence D. Polizzotto*, Exchange Act Release No. 70337, 2013 WL 4773958 (Sept. 6, 2013) (concerning the selective disclosure of news that the issuer would not receive a loan guarantee from the U.S. Department of Energy anticipated by industry analysts); *In re Fifth Third Bancorp*, Exchange Act Release No. 65808, 2011 WL 5865859 (Nov. 22, 2011) (concerning the selective disclosure of the issuer's plans to redeem a class of its securities at a price below prevailing market rates); Complaint, *S.E.C. v. David Ronald Allen, et al.*, Civil Action No. 3:11-CV-882–O (filed N.D. Tex. Apr. 28, 2011) (concerning the selective disclosure of a transaction partner's efforts to obtain outside financing for the contemplated transaction).]

In re Edward J. Marino, [Exchange Act Release No. 66990, 20210 WL 1681308 (May 15, 2012).] shows the type of communication that is likely to draw the Commission's scrutiny. On September 28, 2006, Edward Marino, then the President and Chief Executive Officer (''CEO'') of Presstek, Inc. (''Presstek''), received a telephone call from a managing partner of an investment adviser. The managing partner inquired as to Presstek's performance in Europe during the summer of 2006. As of the date of this call, Presstek had not publicly announced its financial performance for the quarter, though Marino had previously received an email advising him of weak performance in August in both North America and Europe. Despite the fact that this information had not been publicly disclosed, Marino told the managing partner, in substance, that Presstek's summer performance in North America and Europe was ''not as vibrant'' as expected and that it was ''overall a mixed picture.'' That same day, the investment adviser sold substantially all of its shares in Presstek. [*Id*.]

The Commission initiated a civil enforcement action against both Marino and Presstek, which Presstek settled by consenting, without admitting or denying the Commissions' findings, to a judgment enjoining it from further violations of Section 13(a) of the Exchange Act and Regulation FD and imposing a $400,000 civil penalty. Marino later settled the civil charges against him by consenting to entry of a civil judgment imposing a $50,000 civil penalty and the issuance of an administrative order finding ''that he caused Presstek's violations and ordering him to cease and desist from committing or causing. . . any future violations.''

Issuers should also be cautioned that the Commission has initiated enforcement actions even where the individuals communicating on behalf of the issuer did not directly disclose the issuer's financial information. In *Securities Exchange Commission v. Office Depot, Inc.*, [Complaint, *S.E.C. v. Office Depot, Inc.*, No. 9:10-cv-81239 (S.D. Fla. Oct. 21, 2010).] the Commission alleged that Office Depot investor relations personnel initiated a series of one-on-one calls with analysts in the second quarter of 2007. During these calls, the Office Depot officials ''did not directly tell the analysts that [the company] would not meet their expectations; rather, this message was signaled through its references to recent public statements of comparable companies about the impact of the slowing economy on their earnings, and reminders of Office Depot's prior cautionary public statements.'' [*Id*. ¶ 1.] Office Depot continued to make such one-on-one calls after the Chief Financial Officer (''CFO'') was notified that some analysts were concerned with the lack of public disclosure. Office Depot did not file a Form 8-K announcing negative sales and earnings guidance until six days after the one-on-one calls began. [*Id*. ¶ 2.] Office Depot and the company's CEO and CFO ultimately settled the Commission's administrative actions by consenting to civil penalties and entry of cease-and-desist orders prohibiting future violations of Regulation FD.

The Commission has Credited Issuers' Efforts to Deter and Mitigate Violations of Regulation FD Even where it is clear that a person acting on behalf of an issuer made a selective disclosure in violation of Regulation FD, the Commission has sought less severe penalties against issuers that have adopted meaningful internal controls, cooperated with the Commission's investigation, and taken steps to mitigate the effects of the violation.

For instance, *In the Matter of Lawrence D. Polizzotto*, [Exchange Act Release No. 70337, 2013 WL 4773958 (Sept. 6, 2013).] the Commission declined to institute an enforcement action against the issuer, First Solar Inc. (''First Solar''), because the company had ''cultivated an environment of compliance through the use of a disclosure committee that focused on compliance with Regulation FD.'' The Commission also noted that First Solar ''immediately discovered Polizzotto's selective disclosure and promptly issued a press release the next morning before the market opened,'' self-reported the violation to the Commission, and voluntarily conducted additional Regulation FD training for employees responsible for public disclosures. [*see also* Litigation Release No. 21222 (Sept. 24, 2009) (citing the issuer's ''extraordinary cooperation'' with the Commission's investigation of the alleged violation as a factor that weighed in the Commission's decision not to bring an enforcement action against the issuer).] Even in cases where the issuer was ultimately named in an enforcement action, the Commission has rewarded the issuer's efforts to cooperate with the investigation and to mitigate investor damages by narrowing the issuer's potential liability. [*See Matter of Fifth Third Bancorp*, Release No. 65808, 2011 WL 5865859, at *4 (Nov. 22, 2011) (explaining that the Commission did not seek a civil penalty against the issuer due in part to remedial actions taken by the issuer, ''including its compensation of . . . investors harmed by the timing of its disclosure and its adoption and implementation of additional policies and procedures relating to the redemption of securities'').]

Conclusion

Regulation FD obligates issuers to take care in their communications with shareholders and other securities market professionals. Though the Commission has initiated relatively few enforcement actions based upon alleged violations of Regulation FD, issuers' compliance programs should, at a minimum, delineate which personnel are permitted to speak on the company's behalf and set specific guidelines for the disclosure of earnings guidance and other material nonpublic information. In the event that an issuer learns that it has selectively disclosed material nonpublic information to a person covered by Regulation FD, the issuer should notify counsel and take immediate steps to disclose the information to the general public.

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