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Concerning Regulation FD

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises House Committee on Financial Services.

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The Securities Industry Association[1] appreciates the opportunity to offer our views on the Securities and Exchange Commission's Regulation FD. We are encouraged that the Chairman and his Subcommittee colleagues are tackling this novel and complex area of securities regulation. Your interest and the careful attention of the Securities and Exchange Commission ("SEC" or "Commission") will help ensure that information, the life's blood of the U.S. capital markets, continues to flow fully, efficiently and fairly from companies to market participants. Public trust and confidence in our nation's capital markets depends on striking a balance that ensures the maximum amount of information to all market participants. In the testimony below, we will address the issues addressed in your letter of invitation, with particular attention, first, to the impact that Regulation FD has had on the quality of information available to investors and, second, to specific proposals for improving the rule.

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[1]The Securities Industry Association brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member-firms include investment banks, broker-dealers and mutual fund companies that are active in all U.S. and foreign markets, in all phases of public and corporate finance and that account for the overwhelming majority of all securities-related business in North America. More information about SIA is available on its home page: http://www.sia.com.)

Overview

The United States has long had the most vibrant securities markets in the world. Vibrant markets benefit all Americans by giving investors opportunities to make intelligent investment decisions and by helping issuers raise capital to establish or expand their businesses. Our markets have thrived largely because of their ability to obtain, digest and appropriately price information about companies and the economy. Four factors have made this so. First, companies have powerful motives to disclose information. Most issuers understand that their cost of raising capital is lower if potential investors find the company forthcoming in disclosing information about itself. Second, the federal securities laws have long supported the efficient flow of information to the markets, especially by deterring the dissemination of deliberately false information. Third, our markets have been very good at embracing advances in technology, from the telegraph to the Internet. This has enormously enhanced the capabilities of market participants to receive and absorb information in their trading decisions.

The fourth factor is the human element. While technology can pipe great volumes of information onto the computer and television screens of investors, technology alone is inadequate to give perspective and context. Human beings are indispensable for that role. In particular, communications between issuers and securities analysts have contributed importantly to the mixture of information, providing investors with a more textured understanding of the significance of new information, resulting in greater accuracy in pricing and less stock price volatility.

Although there may be differences of opinion about how well Regulation FD is working, all observers share the goals of protecting investors by ensuring that information flows freely to the market. SIA opposed Regulation FD when it was first proposed because we believed that, while well-intentioned, it would have an adverse effect on the flow of quality information to the markets.[2] Notwithstanding our concerns,

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[2] SIA is not alone in believing that hampering securities analysts could impede the flow of information to the markets. As the U.S. Supreme Court noted, an overly broad reading of an SEC anti-fraud rule

the SEC decided to adopt the rule.[3] Although six months is not a lot of time in which to draw firm conclusions about a new rule, we have been able to amass enough information to offer some preliminary observations about how well the rule is meeting its objectives, and steps the SEC could take to reduce the rule's collateral costs while retaining or enhancing its benefits. As we discuss below, our extensive surveys of the impact of Regulation FD on investors, issuers, analysts and securities firms suggest that, while it may have some benefits**,** it is harming the quality of information from issuers, and may be a contributing factor to market volatility.

SIA agrees with the SEC that corporate information should not be treated as a commodity that can be parceled out to bolster the short-term reputation of either corporate management or of favored analysts, or to be misused by recipients. SIA does not believe that this type of abuse has been common in our markets. SIA believes that Regulation FD should be fine-tuned to better address this concern, while minimizing its detrimental impact on the ordinary flow of high-quality information to the marketplace.

> "could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market [citing SEC statement]. It is commonplace for analysts to 'ferret out and analyze information' [citing SEC statement] and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth or a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally."

SEC v. Dirks, 463 U.S. 646, 658 (1983).

[3] As initially proposed, Regulation FD would have barred non-public disclosure of information to *any* person outside the issuer, unless that person signed a confidentiality agreement or was subject to a fiduciary or other duty not to disclose the information. Our principal concern was that the rule would reduce the quality and quantity of information flowing into the markets. We were also concerned that the rule swept too far in other respects, applying, for example, to communications between the issuer and government agencies. As adopted, the rule addressed some of the concerns raised in our comment letter.

A. How Well Has Regulation FD Worked?

SIA has just completed an extensive study of the impact of Regulation FD on investors, securities analysts and broker-dealers. We conducted in-depth interviews with 30 buy- and sell-side analysts and 25 general counsels of issuing companies, a random telephone survey with 505 individual investors, and a survey of 94 SIA member firms representing a cross-section of the industry. Our conclusions, which were released yesterday, present few surprises. Regulation FD has contributed to the public's overall perception of fairness in the market. Unfortunately, Regulation FD also appears to have produced a number of the unintended consequences we anticipated in our comment letter on this issue. Specifically, we have found that Regulation FD:

- Produces some benefits;
- Has produced a "chilling effect," on the quantity and quality of information disseminated by the issuer;
- Imposes significant costs, well in excess of those presupposed by the Commission prior to its effectiveness; and
- Could be a source of volatility in a market-place already experiencing near-record levels of volatility.

Benefits of Regulation FD. Regulation FD has accelerated the healthy trend toward communicating material information to the public and securities professionals simultaneously. It may also enhance the public's overall perception of the fairness of the market. This is an important benefit. Interestingly, however, only fourteen per cent of investors surveyed are making the effort to seek out the information that issuers communicate directly to the public. As noted below, the rule has encouraged analysts to conduct more independent research. This too is a desirable result, but is offset considerably by the lessened ability to "grill" management and to obtain quality information directly from companies. Finally, Regulation FD clearly gives the SEC a powerful regulatory tool to address instances of selective disclosure when they occur, to the extent that there was ambiguity in its legal authority to pursue such cases prior to Regulation FD.

Impact on Quality of Information. Regulation FD has had a deleterious effect on the flow of information from issuers to investors and analysts. The quantity of information has gone up in some instances and down in others. However, the vast majority of analysts and industry observers feel that the quality of information voluntarily put out by companies is inferior to the information that reached the market before Regulation FD was adopted. Seventy two per cent of analysts interviewed by SIA feel that information communicated by issuers to the public is of lower quality than information made public prior to implementation of the regulation. The rule has also made it more difficult for analysts to do their job. While analysts are redoubling their efforts to conduct independent fundamental analysis, losing the ability to closely examine management is a real hindrance. Seventy six per cent of analysts interviewed by SIA say that it is more difficult or impossible for them to obtain from management even non-material information that they need to form a complete picture of the company. Post-FD, it is also more difficult for analysts to play a watchdog role. Prior to the rule it was not uncommon for analysts to dissect and challenge perfunctory press releases in attempts to force more information out of issuers. There are now few opportunities to play this role.

Another by-product has been to encourage the transmission of raw information independent of context and analysis. Thus, the public is now inundated more than ever with raw data – with little or no differentiation as to what is significant and what is not. The media is now in a position to disseminate and comment on issuer information before analysts have an opportunity to add much context to that information.

Direct Costs of Regulation FD. Unlike most SEC rules that apply to some companies some of the time, Regulation FD applies 24 hours a day every day of the year to 13,000 public companies. Regulation FD has created considerable direct costs to companies. SIA estimates that the costs will range from $250 million to $400 million for the rule's first year of effectiveness. This contrasts with the SEC's economic analysis accompanying its adoption of the rule, in which it estimated costs of $49.5 million per year. Some of this represents one-time costs of writing new procedures and taking other steps to adapt to the rule, but a substantial part of the costs relate to making materiality decisions and disseminating the information, costs that may not fall significantly.

Regulation FD's Role in Market Volatility. The increased volatility observed in the markets since adoption of Regulation FD is attributable to multiple factors. While we cannot quantify the impact that Regulation FD may have had on volatility, it is very plausible that the rule was one contributing factor. Ninety per cent of the analysts interviewed by SIA believe that the rule contributes to stock price volatility. Essentially, Regulation FD removes a buffer previously created by analysts and securities professionals. In the new environment, news is blasted into the market, producing an immediate "announcement effect" by which stock prices instantly respond to information that has yet to be analyzed for relevance and import. As additional informational content, context and analysis are released, the market moves to adjust to whatever conclusions are drawn regarding the impact of the information. Thus, in effect, Regulation FD may create a ripple effect for each piece of material information imparted to the market.

B. What Improvements Can Be Made to Regulation FD?

The recent SEC roundtable on Regulation FD produced a well-balanced discussion, and several interesting suggestions emerged. We believe that there are ways to make the rule work more effectively, with less adverse effect on the quality of information and fewer other collateral costs. Below we offer some suggestions that we think would be positive steps from the perspective of everyone interested in or affected by the rule. Among our suggestions, two that we think would be especially helpful would be to clarify the categories of information to which the rule applies, and to clarify the scope of derivative liability under the rule.

Materiality Standard. The most direct and obvious improvement that could be made to Regulation FD would be to develop a more concise definition of materiality solely for the purposes of this rule. The current definition is amorphous and subject to after-the-fact evaluation. There are several approaches that might be helpful. One approach would be to formulate a “bright line” demarcation between material and non-material, thus enabling determination with reasonable certainty of materiality prior to the release or discussion of information. In its adopting release, the SEC laid out the following as examples of the types of information or events that should be reviewed carefully to determine if they are material:

- Earnings information;
- Mergers, acquisitions, tender offers, joint ventures or changes in assets;
- New products or discoveries or developments regarding customers or suppliers;
- Changes in control or management;
- Changes in auditors or notification that the issuer may no longer rely on the auditor’s report;
- Events regarding the issuer’s securities; and
- Bankruptcies or receiverships.[4]

The SEC might consider reformulating its materiality standard under Regulation FD to expressly limit the scope of Regulation FD to material items within these categories.

Alternatively, the Commission might issue a “laundry list” of items, more detailed and precise than the list above, that it considers to be material under the existing definition, indicating that it will view items on the list as presumptively material, while anything not on the list would be presumptively (if not conclusively) viewed as non-material. Conversely, it would be helpful if the Commission could identify items that it considers to be immaterial.

Yet another approach would be to issue an interpretive release revising the analysis of materiality contained in the Commission’s adopting release. That

[4] 65 Fed. Register at 51721 (August 24, 2000). The SEC correctly notes in its adopting release that even these events are not necessarily *per se* material. However, if the scope of Regulation FD were limited to items on this list that are determined by the issuer to be material, information falling outside these categories would be unchained from the chilling effect of the rule.

interpretation could simply refer to the leading Supreme Court cases on materiality,[5] and disavow other materials that the Commission cited in its adopting release which arguably inject confusion into the analysis of materiality.[6]

Finally, the Commission could modify the rule to eliminate materiality. Instead, the Commission could simply enumerate a detailed list, based on further study of the rule, of the types of information that it covers. This approach would be a pragmatic accommodation between the Commission's overall goal of equalizing access to information and the reality that a standard based on the materiality concept is impractically broad in application. It would also enable the Commission to address the widespread concerns about the materiality test under Regulation FD without creating a "super-materiality" standard that might complicate the meaning of the term in other contexts under the federal securities laws.

Derivative Liability. While Regulation FD directly applies only to companies and their officers, it also creates potential liabilities for recipients of information in some circumstances. For example, the Commission might allege that a recipient aided and abetted a violation by an issuer or corporate official. If the recipient was a significant shareholder the Commission might charge it with control person liability.

The Commission staff has suggested that it would only seek to charge a recipient, such as a securities analyst, if he or she threatened or cajoled an issuer or corporate official into divulging material nonpublic information. In the words of a senior SEC official, "it is okay to be persistent and dogged; it is not okay to be abusive and

[5] *Basic v. Levinson*, 485 U.S. 224, 231 (1988); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[6] In its adopting release, the Commission cited its Staff Accounting Bulletin ("SAB") 99 (August 12, 1999) as a source for evaluating materiality. SAB 99 arguably casts a wider net than do the leading Supreme Court cases over the scope of materiality. In particular, SAB 99 suggests that materiality may be judged by subsequent stock price movements, thus reinforcing the widely-held suspicion that the SEC will apply hindsight to issuers' materiality judgments.

threatening."[7] The difficulty here is that it is not clear when an analyst's "persistent and dogged" efforts to build a mosaic picture of an issuer's prospects lead him or her into tough questioning that an SEC official might view in hindsight as "abusive and threatening." There are undoubtedly instances where an analyst may need to be aggressive or even rude to pursue a line of questioning with a corporate official who seems to be evasive. There could be honest differences of opinion on when a line of questioning crosses from "persistent and dogged" to "abusive and threatening," and an SEC officer or other fact finder's hindsight judgment may be little comfort to an analyst trying to determine how strongly he or she can probe in light of Regulation FD. The prospect of being subjected to an SEC investigation, even if no charges result, may discourage the sort of determined probing by analysts that the SEC itself views as socially desirable. As a consequence, the threat of derivative liability jeopardizes the flow of information to investors.

Limiting the scope of derivative liability is also appropriate so that analysts can compete more effectively with the news media to get information to the investing public. As adopted, the rule responded to objections raised by the news media against the proposed rule by exempting the news media from its coverage.[8] SIA respects the important role that the press plays in our society, one that is fully and properly protected by the First Amendment. However, as adopted the rule essentially tilts one "playing field" while seeking to level another one. The investing public is better served when analysts and news reporters can compete to get information out.

Companies are free under the rule to share any material non-public information with the news media, but they are severely restricted in providing such information to

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[7]Remarks of Richard H. Walker, Director, SEC Division of Enforcement, Before the Compliance & Legal Division of the Securities Industry Association, New York, N.Y., November 1, 2000, available at http://www.sec.gov/news/speech/spch415.htm.

[8]Dow Jones objected that the rule as proposed would "inhibit companies from communicating frequently and effectively with the financial press and therefore will limit the flow of information to the investing public." Comments of Peter G. Skinner, Executive Vice President and General Counsel, Dow Jones & Company, Inc., April 28, 2000, available at http://www.sec.gov/rules/proposed/s73199/skinner1.htm.

securities analysts. At a time when many media sites on the Internet and television are increasingly positioning themselves as portals to financial service providers, this sharp disparity in regulatory approach is questionable. Moreover, it is an odd policy result that an analyst might face the threat of regulatory investigation for aggressively trying to probe the facts, while a news reporter trying to "break" the same story might be a candidate for the Pulitzer Prize.

One possible approach might be to craft a safe harbor for analysts from derivative liability. For example, such a safe harbor might protect analysts from derivative liability under Regulation FD if it can be shown that the broker-dealer receiving the information used it for analysis, handled it in accordance with the appropriate "Chinese Wall" procedures required by Exchange Act Section 15(f), and can show that it did not influence any of the broker-dealer's proprietary trading prior to disclosure of the information. Such a safe harbor would better achieve the SEC's goal of not discouraging analysts in "provid[ing] a valuable service in sifting through and extracting information that would not be significant to the ordinary investor to reach material conclusions."[9]

<u>Dissemination Techniques</u>. Regulation FD requires that issuers make public disclosure of information either by filing a Form 8-K with the Commission, or by another method of disclosure "that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public." The Commission's adopting release clarified its views on the meaning of this broad language. Among other things, the SEC expressed the view that press releases and/or invitations to the press may be a satisfactory means of public disclosure, as long as the issuer is confident that the press will in fact cover its news. This position may leave smaller companies, which cannot be certain of attracting press attention, in a difficult position. It may be appropriate for the SEC to reconsider the means by which small companies can satisfy Regulation FD, or consider exempting small companies from the regulation altogether.

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[9] 65 Fed. Register at 51722 (August 24. 2000).

The SEC's interpretive guidance on dissemination techniques is also too inflexible with respect to webcasting conference calls on the Internet. The SEC stated that "an issuer's posting of new information on its own website would not by itself be considered a sufficient method of public disclosure."[10] The SEC went on to say that "in some circumstances an issuer may be able to demonstrate that disclosure made on its website could be part of a combination of methods, 'reasonably designed to provide broad, non-exclusionary distribution of information to the public.' "[11] SIA believes that the burden should not be solely on the issuer to demonstrate in an enforcement investigation that a website posting was a sufficient means of distribution. Rather, the SEC should publish additional guidance on specific circumstances under which a website posting would be sufficient. For example, the SEC might specify that if a company posts a "procedural" Form 8-K setting forth procedures for posting information on its corporate website, it can subsequently rely on website postings as a sufficient means of satisfying the rule's requirements.

<u>Earnings Guidance</u>. The SEC's adopting release for Regulation FD contained some surprising language concerning analysts seeking guidance from issuers regarding earnings forecasts. The SEC said,

> "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."[12]

In proposing Regulation FD, the SEC had not indicated such hostility toward earnings guidance. Consequently, this application of Regulation FD received little attention in any of the comment letters on the proposed rule. As a result of the SEC's

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[10] 65 Fed. Register at 51724 (August 24, 2000).

[11] *Id*.

[12] *Id*. at 51721 (emphasis added).

advisory statement, it is likely that virtually all off-the-record discussion about earnings projections have ceased. This may have some bearing on current stock price volatility. The *de facto* restriction on all discussions about prior earnings guidance seems to be a severe regulatory reaction based on little or no evidence of abuse. It seems especially harsh with regard to simple reconfirmations of existing public guidance on earnings forecasts. Without needing to amend a word of Regulation FD, the SEC could take several helpful steps to mitigate Regulation FD's harmful side effects in this regard. It could issue an interpretive clarification that discussions about prior earnings guidance are not *per se* material, particularly if the conversation only reconfirms existing guidance.[13] It could also offer illustrations of types of conversations about earnings guidance that would not constitute violations of Regulation FD.

Treatment of Unintended Disclosures. In the case of "non-intentional disclosures," the obligation to publicly disclose under Regulation FD is triggered when a senior official learns of the non-intentional disclosure, and must occur not more than 24 hours of that discovery, or the commencement of the next day's trading on the New York Stock Exchange, whichever is later. This creates a number of difficulties, and should be adjusted to reflect practical problems that have come to light. For example, this provision is somewhat problematic for outside directors, who may not be able to readily recognize which pieces of information are material and immaterial, and who, with the press of other business unrelated to the company on whose board they sit, may not readily be able to communicate with company officials. Rather than put outside directors in a difficult position, it might be more appropriate to limit the application of Regulation FD to senior officials responsible for speaking for the issuer with respect to financial matters.

As currently framed this requirement is also impractical for a company located on the Pacific Coast. If senior management of such a company learns of an

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[13] The SEC staff has advised that an issuer's reiteration of previous earnings guidance can be permissible under Regulation FD, depending on how close in time it comes to the previous guidance and whether any intervening events might have called the prior guidance into question. *See* http://www.sec.gov/interps/telephone/phonesupplement4.htm. We believe that many issuers and their counsel have found this advice too heavily qualified to provide much assistance.

inadvertent disclosure over the weekend, they would need to consult the appropriate lawyers, communications people and finance executives before 6:30 AM Pacific time the next business day in order to take action by the 9:30 Eastern opening of the New York Stock Exchange. Some technical modification of the rule to avoid this unfair impact on companies outside the Eastern time zone would be appropriate.

Exemption for Unregistered Offerings. Regulation FD does not fit well as it applies to communications made in unregistered offerings, such as offerings under Rule 144A that are made only to highly sophisticated investors. The SEC stated in its adopting release that it assumed that issuers could comply with the rule by obtaining confidentiality agreements from the recipients.[14] We understand that potential investors in private offerings almost never agree to enter into such agreements, possibly because of the potential legal exposure outside of Regulation FD that such agreements could create. Regulation FD may also slow the offering process in 144A and other exempt offerings. This may increase the expense of the offering, including the interest rate for debt securities being issued.

Like registered offerings, communications in these offerings do not present the potential for abuse that Regulation FD was intended to prevent. We are not aware of any evidence that information shared in private placements ever filters into the secondary market. Long before Regulation FD law firms and investment banks were sensitive to the need, for both registered and unregistered offerings for a company with one or more classes of securities outstanding, to ensure that they did not disclose material non-public information in the offering memorandum. Regulation FD should be amended to exempt Rule 144A and other exempt offerings from its coverage. This would limit the unnecessary intrusion of Regulation FD into areas where there has not been any demonstrated pattern of abuse, and reduce the cost of compliance with the rule.

Harmonizing SRO requirements with SEC requirements. Several weeks ago, the New York Stock Exchange ("NYSE") sent a letter to listed companies saying that the NYSE was not changing its requirement that a press release is the only recognized means for issuing new material information. Therefore, unlike Regulation FD, the NYSE does not recognize the fully accessible conference call as a means for full disclosure. The National Investor Relations Institute has advised its members to put material information expected to be revealed in the call into a news release preceding the call. The NYSE directive goes further and says that if other new material information should emerge from the call, the company is obligated to issue a post-call news release containing that information. SIA believes that is an unnecessary burden both in time, legal expense and the expense of dissemination. We hope that the SEC staff will work with the NYSE staff to eliminate this inconsistency and unnecessary expense.

<u>Conclusion</u>

Mr. Chairman, SIA appreciates the opportunity to share our views with you this morning. We are eager to work with you and your colleagues, as well as the Commission, to ensure that Regulation FD retains and enhances its benefits while minimizing some of the unnecessary constrictions that the rule has placed on the flow of quality information to the markets.

Thank you.

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[14] 65 Fed. Register at 51725 (August 24, 2000).