Regulation Fair Disclosure – An Overview

The 90's brought us faster computers, high-speed internet access and online retail trading, all of which contributed to an increased awareness of the disparity between market information available to professional and retail investors. To address this disparity, in December 1999, the Securities and Exchange Commission, in keeping with its mandates of investor protection and the maintenance of fair, orderly and efficient markets, proposed Regulation Fair Disclosure (Regulation FD or Reg. FD for short), a controversial set of rules designed to level the information playing field by putting an end to the practice of selective disclosure.

Selective disclosure typically occurs when a senior executive of a publicly traded company reveals material information to an analyst or institutional investor before that information is publicly available. Or, to make use of a recent example, when the former CEO and CFO of Office Depot have their director of investor relations contact company analysts and indirectly encourage them to revise earnings estimates by referencing comparable companies experiencing declining results.

The Commission received almost 6,000 comment letters in response to its initial Reg. FD proposal, the majority of them coming from individual investors overwhelmingly in favor of its adoption. In contrast, nearly all companies, analysts and institutional investors intensely opposed Reg. FD, arguing that it would have a chilling effect on the flow of corporate information and ultimately lead to less disclosure.

In August 2000, after much debate, the Commission adopted a scaled down version of its original proposal. As adopted Regulation FD requires that whenever a company, or anyone acting on its behalf, discloses material nonpublic information to certain market participants the company must also disclose that information publicly—simultaneously, in the case of an intentional disclosure, and promptly, in the case of an unintentional disclosure.

It sounds simple enough on paper (or in pixels), but can get a little complicated when put into practice. Hence, before we can look at how Regulation FD might apply in the context of a specific medium, such as on the web, we need to address certain questions essential to an understanding of its application in general. Such as:

Who are the market participants that Regulation FD applies to?

Regulation FD was designed to put an end to the selective disclosure of information to persons who could reasonably be expected to trade on the basis of that information or to provide others with advice about trading. To that end, it applies to selective disclosures made to securities market professionals, such as analysts and institutional investors, and even to ordinary shareholders when it's reasonably foreseeable that they would trade on the basis of the information disclosed.

Reg. FD does not apply to information disclosed to customers, suppliers or strategic partners for legitimate business reasons. It also specifically excludes information disclosed to anyone owing a duty of confidence to a company, such as employees, accountants, attorneys, investment bankers and anyone who expressly agrees to confidentiality.

Who can act on a company's behalf?

Senior company officials, investor relations professionals and any other officers, directors, employees or agents who regularly communicate with securities market professionals or shareholders can act on a company's behalf. By extension, this includes anyone acting under the direction of any of the foregoing persons, meaning that if a senior company official directs an employee to selectively disclose material nonpublic information, that senior official would be responsible for the disclosure and a Reg. FD violation would be triggered.

Persons who selectively disclose material nonpublic information in breach of a duty of confidentiality or trust are not considered to be acting on a company's behalf, regardless of their position, and therefore their disclosures will not trigger a Reg. FD violation (though they may trigger liability under other sections of securities laws, such as the insider trading provisions).

What is material nonpublic information?

Excellent question, but you might not be satisfied with the answer. When the Commission adopted Regulation FD it deliberately chose not to define the terms "material" or "nonpublic", electing instead to rely on existing definitions that were established through case law. That is to say the meaning of these terms has been shaped over time, and may continue to be refined, by a series of judicial decisions. This incorporates an important element of flexibility, making the determination about what constitutes material and nonpublic information a facts and circumstances-based analysis, thus adaptable over time and for different media. However, the capacity to exercise discretion also adds an element of uncertainty, which is part of the reason why companies and counsel tend to tread cautiously when it comes to the use of new media.

As a general proposition, the courts have found that information is:

- material if there is a substantial likelihood that a reasonable investor would consider that information important in determining whether to buy, sell or hold a company's securities, and would view it as altering the total mix of information available; and

- public if it has been disseminated in a manner calculated to reach the marketplace in general through recognized channels of distribution, and investors have been afforded a reasonable waiting period to react to the information.

Determining whether a particular disclosure involves material information and when information that has been disclosed is public are two of the most difficult aspects of complying with Reg. FD, and we'll focus on each of them, in turn, in their own future posts.

When is a selective disclosure intentional?

A selective disclosure is intentional when, prior to making the disclosure, a company, or person acting on its behalf, either knows, or is reckless in not knowing, that the information being revealed is both material and nonpublic. Rather than define "reckless", the Commission again relies on the definition established through judicial precedent, which essentially holds that conduct is reckless if it consists of a highly unreasonable act or omission that is an extreme departure from the standards of ordinary care.

When must an unintentional selective disclosure be publicly disclosed?

Unintentional selective disclosures must be publicly disclosed "promptly" after a director, officer or investor relations or public relations officer learns of the disclosure and knows, or is reckless in not knowing, that the information disclosed was both material and nonpublic. Promptly means as soon as reasonably practicable but in no event after the later of 24 hours, or the beginning of the next trading day on the New York Stock Exchange (regardless of where a company's securities are listed or quoted).

What constitutes a public disclosure?

The public disclosure requirement of Regulation FD is satisfied when an Exchange Act report *(e.g.*, Form 8-K, 10-Q or a proxy statement) is filed with the Commission and made publicly available through the EDGAR database, or when material information is disseminated by a method, or combination of methods, reasonably designed to provide broad, non-exclusionary distribution of that information to the public. The latter, alternative method provides companies with the flexibility to choose any means of disclosure available, so long as it results in a broad, non-exclusionary distribution of the material information. It also brings in that element of uncertainty again.

When Reg. FD was initially adopted the Commission expressed the view that a widely distributed press release or a conference call that was preceded by adequate notice and open to the public could satisfy the alternative method of public disclosure. The Commission also noted that as technology evolved and internet use became prevalent, widely followed company websites might also satisfy the alternative method of public disclosure. This notion was revisited in August 2008, when the Commission issued interpretive guidance outlining the circumstances under which information posted on a company's website would be considered public for purposes of Regulation FD; another topic we'll explore at length in a future post.

As regular *IR Web Report* readers know, most companies that use the alternative disclosure method to publicly disclose material information do so by distributing a press release via a newswire service. This is starting to change, however, as investors have increasingly turned to corporate websites and social media for company information. Large cap companies like Google and Microsoft have already moved from distributing earnings releases via a newswire service to posting them on their own investor relations websites. This is an important first step in establishing the company website as an alternative method of disclosure for all material information under Regulation FD, not just earnings releases, and it's really only a matter of time before other companies follow suit.