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# Comment Letter on SEC Selective Disclosure and Insider Trading Proposals, April 2000

**April 27, 2000**

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

**Re: Proposed Rules Relating to Selective Disclosure and Insider Trading**
**(File No. S7-31-99)**

Dear Mr. Katz:

The Investment Company Institute [1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposed new rules under the Securities Exchange Act of 1934 regarding selective disclosure and certain aspects of the law of insider trading. The Commission's proposal addresses three issues: (i) selective disclosure by issuers of material nonpublic information (Proposed Regulation FD (Fair Disclosure)); (ii) whether insider trading liability depends on a trader's "use" or "knowing possession" of material nonpublic information (Proposed Rule 10b5-1); and (iii) when the breach of a family or other non-business relationship may give rise to liability under the misappropriation theory of insider trading (Proposed Rule 10b5-2).[2]

The Institute supports the objectives of the Commission's proposed new rules—to promote the full and fair disclosure of information by issuers, and to clarify and enhance existing prohibitions against insider trading. We are concerned, however, that while the proposed rules seek to vindicate widely-accepted principles, each rule, as drafted, could produce unintended marketplace consequences. We therefore recommend that the proposed rules be modified in the manner described below to avoid such consequences while remaining consistent with the Commission's stated objectives.

First, we recommend that, rather than using a standard relying on the amorphous concept of "materiality" to determine what information would be subject to disclosure under the rule, proposed Regulation FD be limited to those types of information that are especially likely to have a significant impact on the price of an issuer's securities. We believe this would provide greater certainty regarding the appropriate legal standard for communications between issuers and investors, thereby preventing the rule from having a "chilling effect" on those communications. We also urge the Commission to reaffirm the core principles of the "mosaic theory" as applicable to all research efforts conducted by analysts. Additionally, we recommend that closed-end investment companies not be subject to proposed Regulation FD, because doing so would not serve any apparent purpose.

Second, the Institute strongly recommends that, rather than adopting the "awareness" standard contained in proposed Rule 10b5-1, the Commission adopt a "use" test to determine when insider trading liability arises. We are concerned that an awareness standard could inappropriately expose individuals to liability for activities that do not raise the concerns that the rule is designed to address. Additionally, we support adoption of subsection (c)(2) of proposed Rule 10b5-1, which recognizes the validity of a "Chinese Wall" defense. Finally, the Institute recommends that the Commission expressly limit the application of proposed Rule 10b5-2 to the family and personal relationships for which it is intended in order to avoid inadvertently inferring fiduciary-like relationships in other contexts involving confidentiality agreements.

Each of these recommendations is discussed in more detail below.

## I. Proposed Regulation FD

Proposed Regulation FD is intended to curtail the selective disclosure of material nonpublic information to certain marketplace

participants. The proposed rule would mandate that if an issuer discloses material nonpublic information to any person outside the company, the issuer must simultaneously disseminate that information publicly. (In the case of inadvertent disclosure, such dissemination would have to occur "promptly.") The Proposing Release notes that the Commission is "troubled by the many recent reports of selective disclosure and the potential impact of this practice on market integrity."[3] The Commission infers from this reported conduct that many market participants view the Supreme Court's decision in Dirks v. Securities and Exchange Commission[4] "as affording considerable protection to insiders who make selective disclosures to analysts, and to the analysts (and their clients) who receive selectively disclosed information."[5] The Commission proposes moving the regulation of selective disclosure from the rubric of insider trading to a rule promulgated under Section 13(a) of the Exchange Act.

Proposed Regulation FD would be the Commission's first attempt to regulate the rich and varied informal dialogue that takes place between public companies and the marketplace. These informal communications—analyst conference calls, investor conferences, and "one_on_one" meetings with management of issuers—are an integral part of the information provided to the marketplace.[6] The contacts are important to both sides of the discussion. For market participants, including the Institute's members, these communications represent a fundamental aspect of research. At the same time, issuers that participate actively in these informal contacts experience less volatility in their stock price and lower costs of capital.[7]

These informal contacts require issuers to strike a difficult balance between responding to requests for information on a "real time" basis and not selectively disclosing important information to certain analysts. To the Commission's credit, the Proposing Release frames proposed Regulation FD with this concern in mind. The enforcement remedy is limited to knowing violations of the rule and there is a provision for corrective releases in response to inadvertent disclosures.

The Institute's single greatest concern with proposed Regulation FD centers on its exclusive reliance on the term "materiality," one of the most amorphous concepts in the securities laws. Under the proposed rule, information must be disseminated broadly if it is "material,"[8] that is, if "there is a substantial likelihood that a reasonable person would consider it important."[9] This is a difficult, subjective analysis. Indeed, in Staff Accounting Bulletin No. 99, issued last August, the staff cautioned that while traditional quantitative measures may form part of the analysis, qualitative considerations must be weighed carefully as well. SAB No. 99 notes, for example, that "the demonstrated volatility of the price of a registrant's securities in response to certain types of disclosures may provide guidance as to whether investors regard quantitatively small misstatements as material."[10]

An unqualified reference to materiality is inadequate in the context of informal communications between issuers and the marketplace. These materiality judgments are different from those made while preparing periodic reports, registration statements and other situations in which the issuer controls the content and the timing of the communication. Analyst conference calls and one-on-one meetings require managers who are not lawyers to make difficult materiality judgments literally "on their feet." The Institute is concerned that the uncertainty of this analysis and the constant risk of after-the-fact assessments could chill valuable marketplace contacts. Corporate managers might regularly choose to err on the side of saying too little that is useful or responsive to analysts' legitimate inquiries. Additionally, we fear that less information could increase marketplace volatility.[11]

In light of these concerns, we suggest certain modifications to the substance of proposed Regulation FD, as discussed below. We also suggest that the Commission reaffirm the core principles of the "mosaic theory." Finally, we recommend that the rule not apply to closed-end investment companies.

## A. Scope of Proposed Regulation FD

The Institute believes that the proposed rule should be limited as a remedy for certain isolated abuses rather than clouding all informal contacts with regulatory uncertainty. In this regard, we recommend that proposed Regulation FD specify and be limited to the type of information that is most prone to selective disclosure abuses. When government regulates speech, courts require that this regulation precisely impose the minimum restriction necessary to implement the policy.[12] Making the vague materiality standard the guiding principle for Regulation FD is inconsistent with this approach. Therefore, the Institute suggests that proposed Regulation FD be limited to those types of information that are especially likely to have a significant impact on the price of an issuer's securities. In this regard, the rule's "definitions" section should include a list of such types of information. We recommend that the list include the following:

This list is derived, in part, from Form 8-K filing requirements, recent proposed amendments to that form, and guidance provided by exchanges.

Much of the imprecision in proposed Regulation FD would be eliminated if this list were constituted as one that is exclusive. In that event, Regulation FD clearly would identify information that typically should be disseminated broadly before it is addressed with any one segment of the market. In the absence of such a delineation in the rule, the Institute fears that proposed Regulation FD would invite too much uncertainty. If this uncertainty is not curtailed, it could have the unintended effect of decreasing the real-time continuous flow of information and increasing marketplace volatility.

## B. The Mosaic Theory

The Institute urges the Commission, in its release adopting Regulation FD, to reaffirm the core principles of the "mosaic theory" as applicable to all research efforts. The Commission has long recognized that skilled securities analysts ferret through nonpublic information (itself not material) "to form a ‘mosaic' which is only material after the bits and pieces are assembled into one picture."[13] While this principle has been developed primarily in matters involving "sell side" analysts who publish research on behalf of their broker-dealer employers, it applies equally to "buy side" analysts, including those analysts and portfolio managers for advisers to investment companies.

The Proposing Release makes only a passing reference to the important role of sell side analysts and does not acknowledge expressly the existence of buy side analysts.[14] The Commission's adopting release should underscore that proposed Regulation FD neither limits appropriate market research nor the capacity to benefit from such research.[15] In certain instances, members of the Commission have suggested that recipients of selectively disclosed information should be constrained from trading on the basis of that information.[16] Indeed, the Commission has initiated proceedings related to the use of selectively disclosed material information.[17]

The Institute is concerned that the interests of a broad cross-section of investors would be impaired if, for example, concerns about the scope of Regulation FD caused issuers to curtail individual meetings or conversations with fund investment personnel who have made substantial investments in their companies. The potential adverse impact of this rulemaking exercise would be mitigated if the adopting release includes a statement affirming that the Commission recognizes an inherent right to invest based on a prescient analysis.

## C. Application to Investment Companies

As proposed, Regulation FD would apply to closed-end investment companies. The Proposing Release offers no explanation for this extension of the proposed rule (other than noting that, by contrast, open-end investment companies continuously update their prospectuses and should not be subject to the rule). The Institute believes that no purpose is served by making proposed Regulation FD applicable to any investment companies.[18] For the reasons discussed below, we therefore recommend that proposed Regulation FD be modified to not apply to closed-end investment companies.

First, there is no evidence of selective disclosure abuses by closed-end investment companies. Second, although closed-end investment companies are discussed with analysts, the content of the discussions rarely includes the types of information that likely would lead to abuse. In addition to "macro" information about the marketplace generally, ongoing contacts between analysts and advisers to closed-end investment companies typically concern the fund's current yield, premium/discount, undistributed net investment income or whether the investment company is expected to meet certain distribution targets (if any exist). Any shareholder (or prospective shareholder) could receive most of this information by calling the investment company itself. Moreover, this information does not have the same impact on the marketplace as the information prone to selective disclosure abuses by operating public companies—such as preliminary earnings results, changes in management or the results of a new product.

# II. Proposed Rule 10b5-1

Proposed Rule 10b5-1 is intended to address the uncertainty of whether insider trading liability depends on a trader's "use" or "knowing possession" of material nonpublic information.[19] Proposed Rule 10b5-1 would state as a general principle that insider trading liability arises when a person trades "on the basis of" material nonpublic information "if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale." The Proposing Release acknowledges that enforcement action may be inappropriate when the investment decision was made before the person received the material nonpublic information, and proposed Rule 10b5-1 includes certain affirmative defenses based on that concept.[20]

The Institute strongly recommends that the liability standard in Rule 10b5-1 be "use" rather than "awareness," as proposed. We are concerned that an awareness standard could inappropriately expose individuals to liability for activities that do not involve the misuse of inside information. For example, mutual fund personnel who participate on creditors' committees typically will come into possession of material nonpublic information, while others within their organization who do not have that information may trade the distressed securities. An awareness standard could cause such trading to be considered illegal, or, at the very least, raise legal uncertainty about it. Consequently, if the liability standard were changed to awareness, institutional investors may choose to forgo participation on creditors' committees and in other activities valuable to the marketplace that raise the specter of liability under the proposed standard. [21]

Businesses generally have relied on a "use" standard and structured their compliance systems accordingly because courts that have addressed the issue directly, consistently have determined that the use test "best comports" with precedent under Section 10(b) of the Exchange Act.[22] Section 10(b) proscribes fraud and, in order to prove fraud, the Supreme Court requires proof of manipulation or

deception.[23] In an insider trading context, the manipulation or deception element of Section 10(b) requires a corporate insider to exploit material nonpublic information. If, for example, a corporate insider implements a plan directing certain trades in a company's securities and subsequently acquires material nonpublic information about his company, he does not engage in manipulation or deception by executing his preexisting trading plan.[24]

In subsection 2(c) of proposed Rule 10b5-1, the Commission proposes to provide an affirmative defense to liability for non-natural persons with established "Chinese Wall" procedures in place.[25] Funds have constructed extensive compliance procedures in reliance on the availability of a Chinese Wall defense. The central goal of these procedures is to ensure that while certain employees of an adviser are in possession of material nonpublic information about an issuer, other employees are prevented from knowing that information while they continue to trade the issuer's securities. These procedures have been effective in preventing the misuse of inside information. Accordingly, the Institute strongly supports the adoption of this subsection, whether the Commission adopts a "use" or an "awareness" standard. Adoption of proposed subsection (c)(2) of the rule would be particularly critical to market participants who rely on the validity of such procedures, however, if the Commission adopts the awareness standard in proposed Rule 10b5-1.

## III. Proposed Rule 10b5-2

Proposed Rule 10b5-2[26] is intended to set parameters for when "family or personal relationships create 'duties of trust or confidence' under the misappropriation theory."[27] In cases applying the misappropriation theory to family relationships, appeals courts have required the government to demonstrate that "[a] 'similar relationship of trust and confidence' must be the functional equivalent of a fiduciary relationship." [28] The Proposing Release expresses the Commission's concern that the strict application of this standard leads to "anomalous" results when liability may depend on subtle distinctions in the relationship between the trader and a family member or friend.[29]

While proposed Rule 10b5-2 is intended to address these potential anomalies in insider trading cases only involving family and other personal relationships, [30] the Institute is concerned that the rule could be read to infer a fiduciary-like relationship from almost any confidentiality agreement.[31] Applied outside the context of family and personal relationships, the proposed rule could thus have unintended negative consequences in the marketplace. For example, proposed Rule 10b5-2 could encompass a number of situations in which there is considerable doubt whether investors are reasonably on notice of their "confidentiality obligations," such as informal discussions between troubled issuers and bondholders, Rule 144A offering circulars that purport to bind investors without evidence of their acknowledgement of this obligation, or management presentations at industry meetings with no disseminated guidelines regarding confidentiality requirements. Adopting Rule 10b5-2 as proposed could impose a fiduciary-like relationship between such parties, which could be highly disruptive to relationships that, historically, have operated under assumptions formed by contract or industry practice. These marketplace concerns would be ameliorated by limiting proposed Rule 10b5-2 to the family and personal relationships for which the rule is intended.

* * *

The Institute appreciates the opportunity to comment on these important rule proposals. If you have any questions regarding our comments, please contact the undersigned at (202) 326_ 5815, Amy Lancellotta at (202) 326-5824, or Dore Zornada at (202) 326-5819.

Sincerely,

Craig S. Tyle
General Counsel

cc: David M. Becker, General Counsel
Meyer Eisenberg, Deputy General Counsel
Office of General Counsel

Paul F. Roye, Director
Division of Investment Management
U.S. Securities and Exchange Commission

**ENDNOTES**

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,034 open-end investment companies ("mutual funds"), 496 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.024 trillion, accounting for about 95% of total industry assets, and over 78.7 million individual shareholders.

[2] 64 Fed. Reg. 72590 (Dec. 28, 1999) (the "Proposing Release").

[3] Id. at 72592.

[4] 463 U.S. 646 (1983).

[5] See Proposing Release at 72593.

[6] One 1998 survey covering 227 public companies found that 82 percent conducted analyst conference calls, a significant increase from 61 percent in a comparable 1995 survey. National Investor Relations Institute, A Study of Corporate Disclosure Practices (May 1998).

[7] See Baruch Lev, Information Disclosure Strategy, Cal. Mgmt. Rev., June 22, 1992, at 9 (companies that provide a greater flow of information to the marketplace experience less stock price volatility, thereby creating lower costs of capital). See also Gregory Waymire, Earnings Volatility and Voluntary Management Forecast Disclosure, 23 J. of Acct. Research 1, Spring 1995, at 269 (companies that issue frequent earnings forecasts decrease the volatility of their stock prices relative to those companies that do not issue frequent forecasts).

[8] See Proposing Release at 72594.

[9] SEC Staff Accounting Bulletin: No. 99 – Materiality (Aug. 12, 1999) ("SAB No. 99").

[10] Id.

[11] In the Proposing Release, the Commission recognizes that such concerns are significant and suggests several ways in which they can be mitigated. See Proposing Release at 72594. However, the Institute believes that these mitigation options would be burdensome and impracticable, and thus inadequate to overcome our concerns about the use of a materiality standard. For example, designating a limited number of persons who are authorized to make disclosures would be unworkable in practice because it is impossible to limit interaction with the public to a designated group of people. It is also impractical, as the Commission suggests, to expect an issuer representative to keep records of all private communications with analysts, especially for those communications that take place spontaneously or in response to unanticipated questions. In addition, to have issuers decline to answer questions that raise issues of materiality could lead many analysts to draw, and perhaps publish, incorrect inferences as to why the question was not answered or what the answer may be. Finally, securing the agreement of analysts not to make use of certain information would be burdensome and unrealistic in practice.

[12] See, e.g., Central Hudson Gas & Elec. Co. v. Public Service Commission of New York, 447 U.S. 557, 571-72 (1980) ("When, however, such action involves the suppression of speech, the First and Fourteenth Amendments require that the restriction be no more extensive than is necessary to serve the state interest.").

[13] In re Dirks, Exchange Act Rel. No. 17480, 21 S.E.C. Docket (CCH) 1401, 1406 (Jan. 22, 1981).

[14] See Proposing Release at 72592.

[15] "All reasonable investors seek to obtain as much information as they can before purchasing or selling a security. . . . Therefore, investment advisors seek to obtain as much information including rumors regarding a security as they can so that they may properly advise their clients." SEC v. Monarch Fund, 608 F.2d 938, 942 (2d Cir. 1979).

[16] In a February 1998 speech, SEC Chairman Arthur Levitt condemned trading by analysts and their firms on the basis of selectively disclosed information, stating that "it's just as wrong as if corporate insiders did it." Remarks by SEC Chairman Arthur Levitt, "A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading" (Feb. 27, 1998) (transcript available at http://www.sec.gov)

[17] See, e.g., SEC v. Rosenberg, Litigation Rel. No. 12986, 49 S.E.C. Docket (CCH) 1373 (Sept. 24, 1991); In the Matter of Fox-Pitt, Kelton, Inc., Exchange Act Rel. No. 37940, 63 S.E.C. Docket (CCH) 452 (Nov. 12, 1996).

[18] The Institute concurs with the Commission's conclusion that proposed Regulation FD "would offer little additional protection" to investors in open-end investment companies. See Proposing Release at 72597. As noted in the Proposing Release, because they are continually offering their securities to the market, open-end investment companies must update their prospectuses to reflect material changes. They also may not sell, redeem or repurchase their securities except at a price based on their securities' net asset value, which generally must be computed on at least a daily basis. Id.

[19] The rule was proposed in response to two federal appeals court decisions ruling that, in an insider trading prosecution, the

government must establish the use of material nonpublic information rather than merely its possession. See United States v. Smith, 155 F.3d 1051, 1066-69 (9th Cir. 1998), cert. denied, 525 U.S. 1071 (1999); SEC v. Adler, 137 F.3d 1325, 1332-39 (11th Cir. 1998).

[20] The affirmative defenses would exempt certain transactions – binding contracts to sell securities, written trading instructions, a written sales plan or trading tracking a market index.

[21] Investors benefit when Chinese Walls allow institutional investors to engage in such valuable activities. Bankruptcy proceedings in the early 1990s involving Federated Department Stores, Inc. and Allied Stores Corporation provide a concrete example. On March 5, 1990, the U.S. Trustee appointed in that proceeding notified the official Bondholders' Committee that members of the Committee were precluded from trading the securities of Federated or its affiliates. When an investment adviser filed a motion with the bankruptcy court seeking an order determining that the adviser could continue to trade Allied and Federated securities provided that it implemented appropriate Chinese Wall procedures, the Commission filed an amicus brief in support of the motion, noting that the interests of investors would be served best if institutional investors can commit time and resources to bondholder committee activities. See Memorandum of the Securities and Exchange Commission in Support of the Motion of Fidelity Management & Research Co. at 3, In re: Federated Department Stores, Inc., No. 1-90-00130 (Bankr. S.D. Ohio 1991). The bankruptcy court granted the motion. In re Federated Department Stores, Inc., 1991 Bankr. LEXIS 288 (Bankr. S.D. Ohio, Mar. 7, 1991).

[22] See Adler, supra note19, at 1337; see also Smith, supra note 19, at 1068 ("The Adler court also thought that a 'use' requirement was more consistent with the language of and Rule 10b-5, which emphasizes 'manipulat[ion],' 'decept[ion]' and 'fraud.' We agree."). While the Second Circuit indicated in one decision preceding Adler that several factors "weigh in favor" of a "knowing possession" standard, the court expressly stated that it was "unnecessary to determine whether proof of securities fraud requires a causal connection." United States v. Teicher, 987 F.2d 112, 121 (2d Cir.), cert. denied, 510 U.S. 976 (1993).

[23] See, e.g., United States v. O'Hagan, 521 U.S. 642, 643 (1997) ("10(b) is not an all-purpose breach of fiduciary duty ban, but trains on conduct that is manipulative or deceptive." (citing Sante Fe Indus., Inc. v. Green, 430 U.S. 462, 473-76 (1977))).

[24] While the Institute appreciates the Commission's concerns about the burden of proof that might be created through a use test, the record developed in most insider trading cases should provide an adequate basis to demonstrate _ directly or through circumstantial evidence _ that the defendant used the relevant material nonpublic information. The Adler court addressed this issue by noting that "when an insider trades while in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading." Adler, 137 supra note19, at 1337. The insider, in turn, "can attempt to rebut the inference by adducing evidence that there was no causal connection between the information and the trade." Id.

[25] Subsection (c)(2) of proposed Rule 10b5-1 would provide that with respect to an entity, a trade will not occur "on the basis of" material nonpublic information if: (i) the individual(s) making the investment decision was not aware of the sensitive information; and (ii) the entity has adopted reasonable procedures "to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information." As noted in the Proposing Release, this proposed language closely tracks Rule 14e-3(b). It is our understanding that this approach has worked effectively for entities subject to the rule.

[26] Proposed Rule 10b5-2 specifically identifies circumstances in which a "duty of trust and confidence" may be deemed to exist for purposes of insider trading liability. The circumstances that can give rise to such a relationship include: (1) "[w]henever a person agrees to maintain information in confidence;" (2) a past pattern of shared confidences giving rise to an expectation of confidentiality; or (3) when the information is received from a person's spouse, parent, child or sibling (absent evidence that the person communicating the information had no expectation of confidentiality).

[27] See Proposing Release at 72603. The misappropriation theory provides that a person violates Section 10(b) of the Exchange Act by trading securities on the basis of information misappropriated in breach of a fiduciary relationship or similar relationship of trust and confidence.

[28] United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991), cert. denied, 503 U.S. 1004 (1992). See also United States v. Reed, 602 F. Supp. 685 (S.D.N.Y. 1985).

[29] See Proposing Release at 72604.

[30] The Executive Summary of the Proposing Release states that proposed Rule 10b5-2 addresses "what types of family or other non-business relationships can give rise to liablity under the misappropriation theory of insider trading." See Proposing Release at 72591 (emphasis added). It is also clear from the discussion of proposed Rule 10b5-2 in the Proposing Release that the rule is intended to focus exclusively on family and personal relationships. See Proposing Release at 72603 ("we believe that there is a good reason for the broader approach we propose today for determining when family or personal relationships create 'duties of trust or confidence' under the misappropriation theory") (emphasis added).

[31] Given the stigma associated with insider trading accusations, courts have been reluctant to infer a fiduciary-like relationship merely from the sharing of confidential information. See, e.g., Chestman, supra note 28, at 567 ("[A] fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information.").

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