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FAIR DISCLOSURE OR FLAWED DISCLOSURE: IS REG FD HELPING OR HURTING INVESTORS?

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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FAIR DISCLOSURE OR FLAWED DISCLOSURE: IS REG FD HELPING OR HURTING INVESTORS?

THURSDAY, MAY 17, 2001

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 10:20 a.m. in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives, Ney, Cox, Weldon, Riley, Fossella, Ose, Hart, Kanjorski, Bentsen, J. Maloney of Connecticut, Hooley, S. Jones, LaFalce, Capuano, Inslee, Moore, Hinojosa, K. Lucas, Shows, Ferguson, Israel and Ross.

Also present was Mrs. Kelly.

Chairman BAKER. Good morning. I would like to now call the hearing of the Capital Markets Subcommittee to order and welcome our witnesses, and with brief explanation, explain the purpose of this morning's hearing.

Since 1995 and the advent of online trading, we literally have millions of individuals who are now engaging in investment activity. I have been not surprised, but confirmed my view of this activity as to demographic profiles of those typical online investors with average annual incomes of about $60,000 with net worth less than $50,000.

So in fact, enormous capital flows are into the markets today as a result of the typically described "mom and pop" investor. To that end, there is then a responsibility of the Congress to ensure that the flow of information to those individuals is balanced, fair and appropriate to make educated investment decisions.

With the advent of regulation fair disclosure, understanding the intent was to provide transparency and insight into investment decisions, there was the expectation that this would enhance the ability of that small dollar investor to be treated in similar fashion to the sophisticated Wall Street investor.

On first review, it would appear that that may not in fact have been the result of a well-intentioned regulation. In fact, looking at the potential legal liabilities of a CEO or a CFO in making judgments particularly with regard to forward-looking statements, it may simply just not be worth it. And therefore, the decisions have

been reached to deprive the markets of needed information as opposed to inform the markets.

It is my view, and I think the view of many Members of the subcommittee, that whether you are a $200 investor or a $200,000 investor, you should be treated with equal respect and regard, but that treating both with no information is not the standard by which we conduct a measure of fairness.

For those reasons, the Committee this morning is looking forward to the statements of those who will appear and will engage in a review of this matter over the coming months to determine what, if any, action the Congress should take with regard to ensuring that American investors are given adequate information to make appropriate decisions.

With that statement, I would now recognize Congressman LaFalce who is with us. I do not know that the Congressman would choose to make an opening statement, but I will talk for a minute to make sure that he reflects on that decision carefully, and I am sure off the top of his head he will come up with an appropriate contribution to the hearing this morning.

With that, Congressman LaFalce, welcome, sir.

Mr. LAFALCE. Thank you very, very much, Mr. Chairman. Maybe not the top of the head, but the top of my file. Thanks very much. I think this is a very important hearing and I congratulate you for having it. I welcome our distinguished witnesses today to this public discussion of the Fair Disclosure Regulation, or as it has come to be known, Regulation FD. I think it is a very important reg.

Regulation FD was adopted to confront a serious problem. Companies making selective and important disclosures of material, non-public information to analysts, institutional investors, but not to the public at large. This practice disadvantaged the small retail investor and other market participants who did not have the access or the privileged relationships of analysts and powerful institutional investors.

It undermined the fundamental premise that the market is both efficient and fair because of the broad dissemination of meaningful information to all investors at the same time.

The Rule requires that when a senior official of a company discloses material non-public information to a shareholder or a market professional, then the company must: one, make all intentional disclosures public simultaneously; or two, promptly, for non-intentional disclosures.

In my view, FD is an important and needed step to level the playing field for investors. And the regulation has gone a long way in ending the practice of selective disclosure to industry analysts and powerful institutional investors. It is possible that FD over time may, in fact, encourage companies to communicate directly with their investors in a more fair and transparent way.

In addition, although FD was not precisely designed to do so, it may also help ensure that analysts remain a truly independent source of information for investors. The regulation should encourage analysts who have sometimes inappropriately become cheerleaders for the investment banking industry—and that is all too often the case—to return to the work of objective analysis of com-

pany fundamentals and not rely on the privileged access that permeated the pre-FD environment.

At the same time, I am concerned about claims that FD may contribute to market volatility and I am interested in hearing the panelists' views on this point. The argument, as I understand it, is that the market is often surprised by results in the absence of analyst guidance ahead of official information by companies. One could also argue that the price effect of an announcement may simply be compressed into a shorter time period rather than the several days typical under the old regime of analyst guidance.

I am also eager to hear not only from the SEC, but our other guests as well, about the possible chilling effects that FD may have produced. Perhaps the SEC should consider some specific guidance on what is material to assist companies in their disclosure decisions.

It will also be important for our companies to understand the SEC's enforcement posture as they evaluate their own risk profile.

As we confront claims that the quality of disclosure has suffered, we also must consider that this disclosure framework is in its infancy, and there is much data yet to be gathered. Companies, analysts and investors are clearly adjusting to the important changes FD has brought, and in many ways companies are learning how to communicate in an unfiltered way with their investors, and this will take time.

Over the coming months we will look to the SEC, the securities industry and the investors themselves to guide us on the effects of FD. And I believe today's hearing can be an important first step in this direction. And I again congratulate Chairman Baker and Congressman Kanjorski for bringing this very important and distinguished panel together as we attempt to do our part in protecting investors and in enhancing the efficient operation of U.S. capital markets. I thank you.

[The prepared statement of Hon. John J. LaFalce can be found on page 62 in the appendix.]

Chairman BAKER. Thank you, Mr. LaFalce.

Mr. Kanjorski, did you have an opening statement?

Mr. KANJORSKI. Mr. Chairman, I am going to put most of my opening statement in the record. I, however, have just two areas I wanted to talk about here. From my perspective, individual investors on Main Street should have access to the same information as the pros on Wall Street. The preponderance of the preliminary evidence also indicates that the SEC's regulations tangible and intangible benefits are increasingly outweighing its costs.

It is, however, also too early to know for certain how the Fair Disclosure Rule is working. With time and experience, I expect that the industry's concerns about Reg FD will likely fade as the marketplace becomes more comfortable with the enforcement of the standard.

In the meantime, we should work in Congress to closely monitor the SEC's actions to implement the Rule and appropriately refine its enforcement approach.

I am going to insert the rest of my statement into the record, Mr. Chairman. I just want to congratulate you for this hearing. I think it is very appropriate at this time.

[The prepared statement of Hon. Paul Kanjorski can be found on page 59 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Kanjorski.

Does any other Member have an opening statement he would like to read? If not, I would like to proceed now to our first panel and welcome this morning the Acting Chair of the SEC, Laura Unger, for her comments. Thank you very much for your appearance and participation.

STATEMENT OF HON. LAURA S. UNGER, ACTING CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Ms. UNGER. Thank you, Chairman Baker, Ranking Member Kanjorski and other Members of the subcommittee. I appreciate the opportunity to testify before you today on behalf of the Securities and Exchange Commission regarding Regulation Fair Disclosure, which we call Reg FD.

Reg FD represents a sea change in the way——

Chairman BAKER. Ms. Unger, I am sorry to interrupt. If you could pull that mike just a bit closer, we could hear better.

Ms. UNGER. Oh, sure.

Chairman BAKER. Thank you.

Ms. UNGER. How is that? OK. Reg FD represents a sea change in the way issuers communicate with investors and the marketplace. It is a very timely topic, so we commend the subcommittee for holding today's hearing.

Commissioner Paul Carey could not be here today, but he has submitted a written statement for the record. And Chairman Baker, I was wondering if you could include that in today's proceeding?

Chairman BAKER. Without objection.

[The prepared statement of Paul R. Carey can be found on page 156 in the appendix.]

Ms. UNGER. Thank you. Well, even though Commissioner Carey is not here, the subcommittee still gets a quorum of the Commission, as I am joined here today by my colleague, Commissioner Isaac Hunt.

Issuers selectively disclosing material non-public information to analysts and analysts' clients trading on that information undermine investor confidence in the fairness and integrity of our markets. Reasonable people may differ as to whether Regulation FD is the best cure, but no one disputes that the problem of selective disclosure is a serious one.

I dissented from the Commission's vote to adopt Regulation FD because of the breadth of the Rule. My dissent was not meant to minimize the problem of selective disclosure, but I was concerned that, in an attempt to eradicate actual trading by clients of analysts following a selective disclosure, Reg FD burdened the vast majority of issuers who are good corporate citizens with new disclosure requirements.

Regulation FD embraces a broad parity of information theory by prohibiting issuers from disclosing material non-public information to analysts, absent a confidentiality agreement, without disclosing it simultaneously to the rest of the world.

I was not convinced that adopting a communication rule was the best way to cure a trading problem. I was also concerned about the quantity and quality of information in a post-FD world. Now that the Rule has been adopted, the Commission will enforce Regulation FD the same way we would enforce any other rule or regulation. But during the Commission's meeting to adopt Regulation FD, I did pledge to monitor the Rule's impact on information flow. And last month I convened a roundtable in New York to discuss with the issuers, the media, analysts and investors how the Rule is working. And your staff actually was able to attend, Mr. Chairman.

I do plan to issue a report on the roundtable in the near future. And the report will include the following five observations:

Number one is the time factor. The consensus was pretty clear that it is too soon to assess the overall effectiveness of Reg FD.

Number two is the quantity and quality of information. There is no question that Reg FD has increased the quantity of information provided by issuers, but the impact on the quality of information is a lot less clear. Some participants were concerned that the Rule had led to a decline in the quality of information provided, and we were told that some of the issuers use the Rule as a shield to limit information flow.

Other issuers who are concerned about their top officials making on-the-spot determinations of materiality that could be second-guessed later have retreated to scripted conference calls and other types of presentations.

The third observation would be the need for more guidance. Many issuers at the roundtable were confused about how to deal with questions of materiality under FD and expressed concern that the Commission may be overzealous in its enforcement of Reg FD. They called for additional guidance from the Commission on how the Rule will be interpreted and enforced.

I think it is fair to say at this point that our enforcement efforts will be focused on clear-cut violations.

Number four would be the need for more information dissemination tools. Participants stated that the rules of the self-regulatory organizations, especially the NYSE and NASD, that require the dissemination of a press release, limit the methods of dissemination otherwise allowed by Regulation FD. And they urge the Commission to explore with the SROs other means of achieving this dissemination and expanding the tools available to meet the requirements of Regulation FD.

Number five, the regulation cannot be tied to current market volatility. At this point it is impossible to draw any direct correlation between Regulation FD and the recent volatility in the securities markets.

It was clear from the roundtable discussion that we probably need more time to assess the overall effectiveness of Reg FD and whether any improvements or adjustments to the Rule are appropriate.

Although "FD" stands for Fair Disclosure, and the title of today's hearing plays on that with whether it stands for "Flawed Disclosure." I think that maybe at this time we would say that "Few Days" have passed and that we need "Further Discourse" to figure out exactly where we need to go with this rule.

In this regard, I can assure you that the Commission will consider the issues raised at the roundtable and at this hearing today in deciding what needs to be done with the rule.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Laura S. Unger can be found on page 66 in the appendix.]

Chairman BAKER. Thank you very much, Ms. Unger.

I welcome now Mr. Isaac Hunt, who is a Commissioner of the SEC, and we certainly appreciate your willingness to appear here today, sir. Welcome.

STATEMENT OF HON. ISAAC C. HUNT, JR., COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

Mr. HUNT. Thank you, Mr. Chairman.

Chairman BAKER. And if you would pull that mike close. It is not very sensitive. Thank you.

Mr. HUNT. Ranking Member Kanjorski and other Members of the subcommittee, I am pleased to join my Chairwoman and to have this opportunity to testify before this subcommittee regarding the Securities and Exchange Commission's Regulation Fair Disclosure.

Regulation FD was designed to eliminate selective disclosure of material non-public information. While the goal of Regulation FD to eliminate selective disclosure is almost universally supported, the method employed by the Rule has been controversial from the very beginning.

While the general public strongly supported the proposed regulation, corporations and Wall Street saw an overbroad regulation that would have imposed significant cost. I myself expressed grave reservations regarding the initial proposal. I believed that Regulation FD as it was initially proposed was overbroad.

More importantly, however, I believed it violated one of the basic tenets of securities regulation that President Franklin D. Roosevelt first expressed in his letter to Congress urging the Federal regulation of securities. Quote: "The purpose of this legislation is to protect the public with the least possible interference to honest business."

Regulation FD as originally proposed would have interfered with every communication by a public company where material information was provided. It would have caused companies to publicly disclose simultaneously any material non-public information provided to suppliers, customers, and, yes, even the Government. It would have applied to material non-public disclosures made by any and every employee in a public company. It would have inappropriately interfered in the public offering process where companies seek to raise needed capital.

In short, I believe Regulation FD as originally proposed would have interfered too much with honest business.

The proposals, however, brought thoughtful public comments that helped the Commission and its staff to significantly narrow the effects of Regulation FD. Accordingly, I believe that Regulation FD as revised and adopted appropriately targeted the selective disclosures that we thought presented a problem to the integrity of our securities markets.

Specifically, we were trying to stop disclosure of material nonpublic information by issuers or their representatives to favored analysts or other market professionals who in turn often passed this information on to their favored clients. Those favored clients might then use such information to obtain a trading advantage in the securities markets.

While I believe that Regulation FD as revised enhances the integrity of our markets, which is why I voted in favor of its adoption, I remain concerned about any unintended consequences, specifically the chilling of communications.

At the Commission meeting adopting Regulation FD, I requested that the Commission's Office of the Chief Economist undertake a study to examine the effects of Regulation FD.

The study should seek to determine whether Regulation FD is accomplishing its stated goal and whether there have been any unforeseen consequences such as a chilling of communications or increased market volatility.

I have been advised that any study would need somewhere between a year and two years worth of data in order to properly evaluate the effects of Regulation FD.

I have asked and I am hopeful that the Commission will publish in the very near future the intended methodologies of the study so that we can obtain thoughtful public comment and make any necessary revisions.

Since the adoption of Regulation FD, there have been a few surveys published regarding its effects. These surveys have shown both positive changes and negative changes in behavior of public companies. Some companies appear to have increased the amount of information they provide to the market, including most notably forward-looking information, while others appear to have reduced the amount of information they provide to the market.

In my opinion, all of these surveys have some shortcomings. Although they do not provide us with any definitive judgments on the effects of the Regulation, they do provide the Commission with certain red flags indicating possible problems with the Regulation.

It is now, I believe, incumbent upon us to explore and monitor these areas. We need to evaluate the landscape to see if these problems are anomalies related to the limited timeframe that Regulation FD has been in effect or if these problems are widespread and long-term. I believe the Commission has begun this process with our recent roundtable on Regulation FD mentioned by Chairman Unger.

On the issue of enforcement, I have publicly stated that the Commission is not looking for a test case. This regulation was not adopted to provide our Division of Enforcement with another tool. In fact, I am hopeful that in time Regulation FD will be associated more with our Division of Corporation Finance and Disclosure Practices than with our Division of Enforcement.

I believe that it will take companies some time to fully adjust to this rule. After all, this rule intends to change what has been standard practice for over 60 years. Thus, there is an education process that must take place before we rush to judgment.

Therefore, at this time, I personally would not support an enforcement action in a case that I did not find to be egregious.

Let me emphasize that, as you may know, to date the Commission has not brought a single enforcement case under Regulation FD. This does not mean, however, that our Division of Enforcement will not ask questions when it becomes aware of facts that suggest that the Regulation has been violated.

I am aware that some have suggested that the mere asking of questions by our Division of Enforcement has in some cases caused companies to stop releasing information out of fear of violating Regulation FD.

I do not make light of these concerns, but in my opinion, just as it is incumbent upon us to monitor the negative effects of the rule, we cannot and must not ignore abuses and violations of Regulation FD. Otherwise I believe we risk alleviating the negative consequences of the regulation only at the cost of eliminating our desired goal.

I would, however, like the Commission to consider all of its alternatives when it finds cases where the rule has been clearly violated. In order for the rule to have a prophylactic effect, I do not believe every case requires us to seek penalties.

In conclusion, Mr. Chairman, I believe Regulation FD is an important and appropriate rule for maintaining the integrity of our markets, but it must be monitored carefully to ensure that it does not result in less information being disclosed.

It is my current opinion that it is just too early to come to any final judgment on the rule. Companies are still becoming familiar with it, and as they become more accustomed to its application, I am hopeful that more, not less, information will be disclosed.

I should note that specific guidance on any particular fact pattern can be obtained any day by calling our Division of Corporation Finance. Additionally, frequently asked questions and significant telephone interpretations of the rule can be obtained on our website 24 hours a day, 7 days a week.

Thank you again, Chairman Baker and Ranking Member Kanjorski for permitting me to testify before you today.

Chairman BAKER. Thank you very much, sir, for your statement.

Chairman Unger, in trying to get my understanding around this issue, it appears that timing of the flow of information is extraordinarily important. Someone telling me today that Edsel would go out of business is probably not financially significant. But someone telling me that Corporation X had secured a patent and that the medication would fix a significant problem in society today and nobody else knows it except me and the corporation would probably be a pretty valuable thing.

So the delivery and timing of information to all parties is the goal. But when I look at Reg FD—and I understand both of you have testified that no action is warranted today until we have better understandings of its impact—but if you look at the construction of it, we prohibit executive-level individuals from communicating preferentially with the market participants. It does not prohibit mid-management. It does not eliminate the natural ability of markets to engage in exchange of whisper numbers.

So rather than the CEO, who has a broad view of the condition of the company talking informally with the analyst who is going to be coming up with the consensus earnings projection for the next

report, we now have the necessity to abide by the law to go to mid-management, who may have a narrower view of corporate performance, and therefore perhaps give less reliable information to the analysts which they manage.

And I say that with some degree of certainty that corporation management and analysts tend to talk to one another, because the corporation does not want to have an earnings expectation that is too high, therefore underperform.

And I have been somewhat amazed. In the dot.com arena, a corporation that loses 6 cents as opposed to the consensus of 8 cents has a run-up in value, while a brick-and-mortar corporation, who earns 9 cents instead of 10 cents, has a runoff of market cap. It just makes no sense at all.

So to make a fair disclosure about what goes on in business practice, we do have corporate executives who share information in advance with the analysts who are trying to come up with a consensus estimate which needs to be a penny or two below the whisper number so that they can then exceed market expectations and see investors flock to this unexpected great news. How are you going to stop that? And does not Reg FD, based on those observations, simply complicate the ability for that mom-and-pop investor we talked about, 800,000 trades a day, the huge run-up in mutual fund investment, IRAs? You name the investment strategy.

It is individual Americans, working families, that are responsible for the enormous capital flows into the market. And it is very difficult to look at the way the system works today and feel like they are being treated on anywhere near an equal footing with the professional analyst. Make me feel better, please.

Ms. UNGER. I am not sure you are making me feel better. I think Reg FD preserved the ability of analysts to have conversations with mid-level management in order to preserve the mosaic theory, which means that you can communicate pieces of information and transmit pieces of information, none of which is material in and of itself, but taken as a whole would lead to a material piece of information or conclusion.

Chairman BAKER. But the problem with that point, something becomes material when a person trades on the basis of that information. So at the time of its release, it might not be in the executive's mind material.

Ms. UNGER. That is right.

Chairman BAKER. But to the recipient, it becomes material.

Ms. UNGER. In theory, it enables the analyst to collect the information and have these communications. And I believe the thinking would be that the analyst would not have the same level of faith or confidence in a mid-level management projection as they would in a CEO's projection. So it would really only be a piece of the due diligence the analyst was conducting with him.

Chairman BAKER. But that in large measure is a result of whether you lose money or make money. If you lose money, you talk to your lawyer. It becomes material and you sue him. If you make money, you are very happy and you go about your business.

Ms. UNGER. Well, this is part of the problem with Reg FD. If Reg FD was originally articulated to get to the problem of an unfair trading advantage, that is a very different problem than a commu-

nication issue. And as you know, the Supreme Court has rejected parity of information and has acknowledged that the corporate management and analysts community have, I believe, walked on the tightrope, or something along those lines, for a number of years, and the value of that relationship.

When you get to limiting the communications of company management with the investment community, I think you do run into certain risks that the information collected by the analyst, or gathered by the analyst in the analyst's research of the company and its earnings or whatever information the analyst is collecting, might not be as precise as the information the analyst was receiving before.

That is the tradeoff of Regulation FD. It requires the analyst to consult several sources in determining an earnings projection, for example, as opposed to just getting it from the mouth of management. And I do not know whether we know at this point whether that is good or bad. Obviously you have heard many different views about that.

Chairman BAKER. Thank you. I have exhausted my time. Hopefully we will come back for another round.

Mr. Kanjorski.

Mr. KANJORSKI. Following up on what Mr. Baker said, it seems that apparently we have identified some sort of a problem, which the regulation was put together for the purpose of solving. Does the regulation as it is structured end up not directing itself at the problem and do we have a solution that is much broader than was necessary? Apparently, all publicly traded companies must deal with FD regulations. Is that correct?

Ms. UNGER. Yes.

Mr. KANJORSKI. And so even small companies on the over-the-counter market have the same costs of going through the process of making sure that the information is out there. Was it intended by the Commission that there was a problem with larger companies or with smaller or mid-size companies? What information was getting out there that appeared to be unfair?

Ms. UNGER. The problem as it was originally articulated was that there was trading activity before or around the time of analyst calls that revealed information about earnings and earnings projections. That indicated to our former Chairman and others that there was material information being conveyed during these calls that was causing the analyst to either trade on that information or pass that information onto his favorite clients who then traded on that information in advance of the marketplace having that information.

The reason the SEC could not bring a case for insider trading under those circumstances, which you would think would be the logical next step, is because in 1983, the Supreme Court said there is no duty owed by an analyst to the issuer because there is no relationship of trust and confidence between the issuer and the analyst. The analyst, in theory, works for the retail investors to whom they disseminate that information.

Therefore, without a duty, there can be no breach of that duty. Additionally, the insider who provided the information to the analyst did not breach his or her duty to the company because he did not receive a benefit for providing the information to the analyst.

And without a breach of that duty, there can be no passing of inside information and no violation of Section 10(b) and Rule 10(b)(5). Is that more than you wanted to know?

Mr. KANJORSKI. Not really more than I wanted to know, but I can see your problem in how to cure it. I am just wondering whether——

Ms. UNGER. We had two choices basically. One was to read a duty into that relationship, or two, to prohibit the communication of the information. Rather than read a duty into the relationship and lay the predicate for a 10(b) violation, we prohibited the communication. Therefore, the issuer cannot transmit material nonpublic information to the analyst without transmitting it to the rest of the world simultaneously or within 24 hours afterwards if the disclosure is inadvertent.

Mr. KANJORSKI. Why can that not be accomplished by just requiring the firms, when they talk to analysts, to talk publicly?

Ms. UNGER. Well, I think that was the tried. And in fact, that was part of the reason for my dissent. Why regulate communication when, in fact, the internet is making it very feasible for companies to make this information publicly available. Before, you did not have the possibility of webcasting your analyst calls. Companies can now provide a lot more access than they could have in the past and at a reasonable cost.

Mr. KANJORSKI. How large of a problem did the former chairman think this was? Was it 50 percent of the transactions that had insider information? Was it 5 percent? Was it 1 percent?

Ms. UNGER. You know, I do not know the percentage. Do you know that, Commissioner Hunt?

Mr. HUNT. No. I do not think we know how to quantify that, Mr. Kanjorski. I think many of us thought that there was a perception in the market that there was trading on selectively disclosed information by market participants who had access to that information. And the purpose of the regulation was to, insofar as possible, create a level playing field for those who had access to such information and those who did not.

It can never be a totally level playing field, and we know that. But it was an attempt to level it as much as we could.

Mr. KANJORSKI. I come down on the side that every investor is entitled to the same information, although I think the difficulty is in how you accomplish that objective. I tend to agree with you, Ms. Unger, that with the internet today, it should be relatively easy to provide investors access to information without a lot of expense. Thus, the person that really is a Main Street investor could acquire important information as soon as an analyst does.

But on the other hand, I weigh it against the burden, particularly on smaller capitalized companies, to police this regulation internally. Smaller companies may ultimately be put upon, either by disclosures that were not intended by the leadership of the company but occurred by people who are less faithful or did not carry on their fiduciary relationship to the company and talked to outsiders. They could later be charged with some violation.

Moreover, it would be horribly expensive. I mean, an SEC suit against General Motors for insider trading is a flick in legal ex-

penses. But, to a relatively small startup company, it could be disastrous and put them out of business.

Ms. UNGER. I just want to clarify two points. One is that Reg FD only applies to the highest level of management. So, in the scenario that the Chairman was laying out, again, you could talk to middle management in collecting the information, but the company would not be on the hook for any disclosure made by that middle management unless senior level officials were deliberately conveying information through middle management in an effort to circumvent Reg FD.

And also, Reg FD is a disclosure requirement. So there is no basis for 10(b) action or an insider trading action. And there is no private right of action for an FD violation.

So in that regard, while the threat of litigation is still something substantial to most companies, it is not as substantial perhaps as a private class action case involving a 10(b) violation.

Mr. KANJORSKI. But, even a lawsuit by the SEC for enforcement to a relatively undercapitalized company could break it.

Ms. UNGER. Absolutely. We have heard a lot about that. That is right.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Cox.

Mr. COX. Thank you. And thank you both for being here with us this morning. Chairman Unger, is the post-Dirks concern trading or inefficient dissemination of information?

Ms. UNGER. I think the concern was first expressed as trading. But as the alternatives to how to cure that problem, or perhaps lack of authority, emerged, it became a communication issue. The former chairman chose to address this issue through disclosure requirements as opposed to, again, reading a duty or a judiciary relationship between the issuer and the analyst.

Mr. COX. So as you look at this today, do you think that if the regulation were withdrawn altogether, if you can imagine it were just gone, that the lion's share of the problems that would be created in that vacuum would be people acquiring information selectively and then trading on it or disseminating it in a way that was uneven?

Ms. UNGER. I think there is nothing wrong with everybody having equal access to information if it is feasible. But the Supreme Court has never said that there is an absolute right to a parity of information. And it is, in fact, unreasonable to expect that everybody would have equal information.

Mr. COX. Yes. I am just trying to discern what the greatest concern is about. Is it about people acquiring information?

Ms. UNGER. I think that is what it has evolved into.

Mr. COX. About people acquiring information and then doing what with it? Trading on it?

Ms. UNGER. The problem is, it is not something—it was not my concern, so I am having a hard time answering you only because I am trying to read someone else's mind who is not here at the table. But my observations are that it started out being a problem with respect to trading and a lot of trading activity around the time of the analyst's earnings call with the company.

And rather than bring a case and test whether we had the authority to say, "OK, that information was disclosed for improper purposes, which would take you perhaps into an insider trading violation. . . ." As I know, you know the case law very well, and rather than make that test case, the idea was to maybe cast a wider net and say, "OK, those communications are improper." Nevermind the duty. We do not even have to look to the duty, because we are going to say that you just cannot make that information available on a limited basis. You have to disclose it to everyone simultaneously.

Mr. COX. I probably should not ask such a distinguished witness when I could ask my staff and probably get the answer. But I am just going to display my ignorance. Has there been any private litigation since the adoption of the regulation based upon violation of the Reg?

Ms. UNGER. No. As I mentioned to the Ranking Member, there is no private right of action under FD, because it is a disclosure obligation. And in fact, we made very clear, I think, in the release that it would not be the basis for a 10(b) violation to avoid the specter of litigation.

Mr. COX. I did hear that exchange, but in my view there is a constitutional right to file bad lawsuits.

Ms. UNGER. Right. We have talked about that.

Mr. COX. And so oftentimes people style—they do their best to try and at least rely upon something such as this in constructing a cause of action that they are entitled to bring, for example, under 10(b)(5) or in some other way. To your knowledge, has that ever occurred?

Ms. UNGER. To the best of my knowledge that has not occurred, nor has the Commission brought an action, which you probably heard also. We have about a half a dozen investigations at this time, but we have not brought a case.

Mr. COX. And so from the standpoint of the issuers, do you believe that the entirety of their concern is Commission action?

Ms. UNGER. I think there is a lot going on. I think the issuers or the companies are trying to do the right thing in terms of following the rule. Nobody wants to be the first Reg FD case. I think these are all good corporate citizens that we are talking about when I am saying "nobody" and talking about companies in general. Nobody wants to have a case brought by the Commission saying, "Well, you committed a securities law violation here; you did not follow the regulatory requirements of Reg FD. "They do not want to be the first one. So people are reticent to make disclosures beyond what has been scripted or what has been specifically said or outlined that they can say.

So I do think that is having a negative impact on the information flow.

Mr. COX. Well, my time has expired, but I would invite Mr. Hunt to reply to any of these questions that arouse your interest.

Mr. HUNT. Well, thank you, Mr. Cox. I think that my concern—and I was in favor of the regulation and worked hard to narrow it so that it was more reasonable. My concern was the disclosure matter that when people got selectively disclosed information, par-

ticularly people in the analyst profession, it would be passed on to their favorite clients.

Their clients would trade on that information ahead of the general marketplace knowing about that information, and that was a clear perception in many people's minds that that gave the people who had close relationships with these analysts who had close relationships with the issuers a clear trading advantage over the average investor in the marketplace today, you know, the individual investor who has come in the market in such great numbers in the last decade or so.

So I thought the rule was a rule to, insofar as possible, level the playing field vis-a-vis the information available to the general investing public.

I also want to emphasize that Regulation FD does not prohibit one-on-one conversations between analysts and the chief executive of a company so long as no material nondisclosed information is not revealed in those discussions. And so when we talk about the mosaic, we assume that analysts usually have more information, more background about the industries and the companies they follow.

There is nothing in Regulation FD that prevents that analyst or small group of analysts from having a discussion with a chief executive of a registrant to fill in background material which may be more useful, is probably more useful to the analyst because of his knowledge and sophistication, than it would be to the general member of the investing public.

The important thing we were trying to do was to make sure that material information was disclosed to everybody at the same time.

Chairman BAKER. You have expired your time, Mr. Cox. I guess I would surmise this. That the goal is to provide information. The next level may be to sue if you do not understand it. And that would be even a more difficult standard, I think, to meet.

Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman. I was listening to the pager. And I appreciate the opportunity to ask a question.

Ms. Unger, I am new to this process, and I was not here when the Reg FD was passed. But reading the materials and listening to your comments and answers to the questions of our leaders, I am going to ask you, it seems that when analysts are looking at a corporation and judging their estimates, financial statements and so forth, they have software that they can use to plug all that information and make a comparison of their financial statements and disclosures.

And so they still have an advantage of being able to call mid-management and asking them for additional information. So it seems like the Regulation FD was one that has been in place a short time, not long enough for us to want to do away with it.

Is it true that in spite of having it in the last 12 months, we have had cases where large corporations have wanted to buy another large corporation and that the information that top management gave besides the financial disclosures were possibly in question, and that is why the purchase of that other company didn't take place? And then when the announcement was made that this giant was buying another large company was not going to through, then

the smaller of the two companies sued the large one because their stock went down.

And I don't want to disclose names, but it's in the food industry. And the question that I ask you is, it still happens in spite of Regulation FD. They talked to the highest of management, and it still happens that the information supposedly is not reliable. So would it be your opinion that maybe we should keep this Regulation FD for a longer period to let it be tested?

Ms. UNGER. It has only been 6 months since the rule has been implemented. I do think that was one of the findings from the roundtable, whether people liked Reg FD or didn't like FD, was that more time is needed to really assess the impact of FD on the quality of information. And, perhaps it was possible for the Commission to have more of an exchange with the corporate community and provide more guidance informally in order to perhaps educate people better on how to comply with the rule and that maybe this is just a period of adjustment.

Mr. HINOJOSA. Mr. Hunt, you said that when you first saw it implemented and enacted that you felt comfortable, and now that you're having second thoughts. Based on my comments, would you disagree with me?

Mr. HUNT. No, sir, I don't think I quite said that. I said when we first proposed it I expressed concern because I thought as originally proposed it was overbroad. I think people in the building on the staff and at the Commission level worked very hard to narrow it, and by the time we adopted it, I thought it was an appropriate disclosure rule that precisely got at the selective disclosure we were concerned about and did not impair the ability of management of a company to communicate with others such as clients or suppliers or even the Government.

We were trying to prevent the selective disclosure of information that we thought could affect the marketplace because it was going to analysts and then going from analysts to their favorite investment customers. And that's all the rule does now is limit that information from the issuer to investment advisors, broker/dealers and analysts who might use that information either to trade or to allow their customers to trade ahead of the market knowing that important material information.

Chairman BAKER. Mr. Hinojosa, your time has expired, sir.

Mr. HINOJOSA. Thank you, Mr. Chairman.

Chairman BAKER. If I may, I'd like to recognize Ms. Hart perhaps for a round of questions. Ms. Hart, did you have a question?

Ms. HART. No.

Chairman BAKER. Dr. Weldon. It would be my intent for your series of questions to be the last before we briefly recess for the vote. We have about 9 minutes or so remaining on the vote.

Dr. WELDON. Thank you, Mr. Chairman. I will not consume 9 minutes, I assure you. I just have a quick question.

I apologize for missing your testimony, both the witnesses. And I don't know if you covered this in your testimony. I was wondering about a cost benefit perspective of the rule in light of the widespread criticism that the rule led to higher volatility in the market and lower quality of information to investors. What is your opinion about the cost benefit?

As I see this, this is—if you listen to both sides on the issue, the impression that you get is that there's some good and bad. And maybe you can't answer my question. Maybe it's too complicated. But take a stab at it, please.

Mr. HUNT. Do you want to do it? Or do you want me to do it? Either one.

Ms. UNGER. All right. We'll both speak on this one. I think the cost benefit analysis at the time the rule was adopted couldn't possibly have predicted the market volatility that we're seeing independent from Reg FD. And I don't think anyone in this room would attribute the current market conditions solely to Reg FD.

So I think it makes it a lot harder to determine what if any contribution FD has had to volatility in a particular stock. Rather than having earnings management or a sort of a gradual introduction of information into the marketplace, perhaps some people are seeing more abrupt earnings announcements and failure to meet earnings projections, and that could have some impact on a particular company's stock volatility.

But as far as the rule overall and the impact on the market, as Commissioner Hunt said earlier, it would take 1 to 2 years to study that impact. This is not to say that we are not going to go ahead and do it, but it will be a little bit of time before we really know the answer to that question.

Mr. HUNT. Mr. Congressman, I think that as Ranking Member Kanjorski mentioned in his queries to Chairman Unger, one of the things we are monitoring very closely on a cost benefit analysis is the effect of this rule on smaller issuers.

When we had our roundtable in New York late last month, one of the comments we received from several large issuers was that complying with this rule is no problem to us. We have the resources, we have the staff, we have the experience to make sure that we have no selective disclosure. But we, they said, are concerned that this rule may have unintended adverse consequences on smaller issuers who do not have already in place the resources and the staff to monitor very well the disclosures that their management make to the analyst world.

So that is one of the effects of the rule that we are trying to watch very carefully.

In terms of volatility, I agree with Chairwoman Unger that given at the time we promulgated this rule and what was happening in the market at this time, I don't think there's anybody in this room who could say to what extent Regulation FD had, or didn't have, an effect on the existing volatility in the market.

Dr. WELDON. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Dr. Weldon.

At this time, we would recess for the vote on the floor. Members have expressed an interest in returning and asking additional questions. So with your continuing patience, we will resume our panel in just a moment. Thank you.

Ms. UNGER. Thank you.

[Recess.]

Chairman BAKER. I would like to reconvene the hearing of the Capital Markets Subcommittee and again welcome Ms. Kelly, who

is not a Member of the Committee, to our hearing today and recognize her at this time for her questions.

Ms. KELLY. Thank you very much, Mr. Chairman.

One of the criticisms of the rule that's been raised about the rule is about its materiality, that its materiality standard is amorphous. It's subject to sort of an after-the-fact evaluation. And I'm wondering if the Commission shouldn't address this problem.

I mean, why not formulate a bright line rule between the material and non-material information in some other way, some way that is perhaps more workable?

Ms. UNGER. Well, Congresswoman, you know that materiality is a concept that is well understood, maybe not well understood in this particular context, but in the Federal securities laws. It has been around for a number of years.

I think the biggest challenge about materiality in the context of Reg FD is again that you are talking about communications. Normally when we're talking about materiality, it's in the context of a document. It is fairly easy to sit down and examine whether something is material or not, rather than to have a conversation and then think, "Oh my gosh, did I just say something material? Do I have to disclose that?" Which is why I think we're hearing a lot of anecdotal evidence that people are sticking to scripts or to predetermined pieces of information in terms of what they will disclose.

In this area, one thing that I think may have sort of confused the issue a little bit for some people is that Reg FD included in reference to materiality a SAB, SAB 99, which is a Staff Accounting Bulletin on materiality. And that's fairly new to some people. So that could be part of the confusion.

We could, however, consider adopting more guidance in terms of examples of types of information that maybe we wouldn't consider material. And that's something I think we'll consider in reviewing what was discussed at the roundtable in April where we can provide more guidance on materiality.

I don't think you want a specific definition that applies only to Regulation FD, however. Because there are many contexts in the Federal securities laws where materiality is an issue.

Ms. KELLY. The reason that I'm here is in my capacity as the Chairwoman of the Oversight Committee. So I'm going to ask another question. In adopting the release, the Commission cited its Staff Accounting Bulletin 99, which arguably casts a wider net than the established Supreme Court cases over the scope of the materiality.

But given that the SAB 99 suggests that the materiality may be judged by subsequent stock price movements, does the SEC intend to apply hindsight to issuers' materiality?

Ms. UNGER. Well, the SAB 99 I did just point out to you is a reason that people might have a little bit less certainty as to what materiality means in this context.

And there has been a Second Circuit decision that has said that SAB 99 and its interpretations are consistent with existing interpretations of materiality. And the case—I actually have it here—is *Ganino* v. *Citizens Utility Company*. And so that has spoken to

whether the SAB 99 is consistent with previous Supreme Court interpretations of what materiality means.

As I think Commissioner Hunt and I have both indicated today, we don't intend to try to make an example of someone who makes an inadvertent disclosure or a good faith mistake in terms of complying with Regulation FD. So no, I think the answer to your question is no.

Ms. KELLY. Good. Thank you. I'm wondering about what the SEC is going to view as "intentional" statements of material information. For example, if a corporate CEO is in the midst of a discussion with analysts and knows that the response to a question is material, does the CEO refuse to answer the question? I have some problems with the fact that I think there needs to be some more bright lines drawn, some more information. I think people are confused about this.

You know, if you get involved in the heat of a discussion and you're the CEO and you respond and you've got material information that you respond with because you're involved in this discussion and you feel that it's important to say whatever you're saying, would the SEC prosecute the CEO for a violation?

Ms. UNGER. I think the rule as drafted—and Commissioner Hunt might have something to add to this—is more geared toward intentionally making a statement. You know, perhaps picking up the phone and calling an analyst and intentionally disclosing something that is material and non-public and not simultaneously disclosing it to others.

If something comes up in a conversation and a CEO answers it and then realizes, "Ooh, that might have been material," there is a period of time where that CEO can disclose that information and not be in violation of the rule. So, again, that is a way to cure that type of inadvertent dissemination of information.

Ms. KELLY. I understand that that is a 24-hour window only. I'm wondering if that is enough time. I realize I'm out of time. But I would perhaps like to talk with you a little bit more about that. Maybe we could talk——

Ms. UNGER. I think we hadn't heard so much that it was the time that was the issue, but really, the reluctance to engage in the dialogue. And we heard some anecdotes at the roundtable, and there was a subsequent mirror roundtable where people were just saying see my earnings guidance. So they weren't answering at all. And do you lose something when that happens? I think probably you do.

Ms. KELLY. Thank you very much, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Kelly.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. Let me start out by saying, first of all, this is a very interesting topic and hearing. I have to say I am a little disappointed that we don't have Mr. Levitt here since he was the originator of this rule, and if for no other reason, to get some of the institutional history and what his intent was behind this.

And given that I don't think Mr. Levitt—I never really put Mr. Levitt on the consumer side of the camp. And while he wasn't a

securities lawyer, he certainly was a practitioner and I think had a pretty good understanding of the securities markets.

But that being said, I do think we would benefit from his input. That being said, I think that our colleague, Mr. Cox, started to hit on what the issues are here. And I'm not sure we have determined whether the issue is the efficient dissemination of information or its effect on trading. And, Ms. Unger, you point out that the marketplace has changed, that there's greater access to information or the ability to disseminate information is much easier today than maybe it was—or certainly than it was 10 years ago or 20 years ago.

I would add to that that I think the investor community, the investor class has expanded dramatically in the last 10 years. And that the role of the securities analyst has changed somewhat. The securities analysts are not the primary disseminator of market information that they once were, given those other changes.

And I think that's good. But at the same time, something like Reg FD it would seem to me that it was designed to not give one sector of the investor class, if you will, the benefit to information that the other sector might not get. And it does seem to me that public companies do talk to investors and do want to give them information, certainly not for illicit purposes and certainly not for insider trading purposes, but rather to try and tell their side of the story so that that when the analyst turns around and puts out their report that the market will react somewhat positively to either an upside or a downside potential.

And so, you know, I think you could look at Reg FD and say that was the direction that it was going in.

Now I think there is another problem that exists as well, and I think this is where Mr. Cox was going, and that is on this vacuum. There is a vacuum as information becomes more readily available, as the investor class grows, and as the use of analysts is somewhat devalued, you have a gap between 10Q's and the information that's available and a gap between offering documents in 10Q's and who is able to get that information.

And I am curious whether you think—I haven't read your statement. I guess what you're saying is it's too early to tell what the impact of FD is going to be. And you had your roundtable and there was a difference of opinion with respect to that.

But I'm curious whether or not the SEC is looking at Reg FD and the broader implications of the changes in the marketplace to where we might be moving away from or beyond quarterly dissemination of material information to even more frequent required dissemination of material information. Now I don't know that you can go to instantaneous at this point in time. But, you know, maybe in 100 years or 50 years or 25 years, you might do that.

But is the Office of Economic Analysis or is the SEC looking at this? And do you think that's where we're headed?

Ms. UNGER. I actually have thought about that particular issue. In the era of the internet when everything is instantaneous, what's the point of having annual reports that have a 90-day lag time in information? By the time that information is publicly filed, it's pretty much already out in the marketplace in some other form or another. And what meaning does that have?

And I have talked to the accounting industry about this issue and the notion of having real-time information available about companies and whether anyone's given thought to that. And in fact the accounting industry has. And the way they approach it is by reviewing a company's internal controls and validating that measure of a company. That way, when that company makes some type of disclosure, there will be a rating attributed to their internal controls and management and the credibility of the information then generally disseminated by that management.

That's probably a long way away. Maybe not so long. But certainly it's not going to happen in the next year or so. And in the meantime, I think what we're trying to do is figure out how we can best use the power of the internet to fulfill the mandate of the SEC, which is full disclosure and now fair disclosure, and how we can make that information meaningful.

And the tricky part is, when you have the opportunity to promulgate a rule like Regulation FD, well, what do you do in terms of providing the ability for companies to disseminate the information? Right now we say it has to be done through a press release, but you can then point investors to the internet in terms of where they will find the information being disclosed.

So we have many challenges involving instantaneous information and the dissemination of information and how investors fit into the internet age. And I guess Reg FD is just one of the first steps. Have I answered your question?

Mr. BENTSEN. Well, no, no. I was going beyond it. I was just making a comment on FD. I do have some more questions, but I'll wait til another round. So, thank you.

Chairman BAKER. Mr. Ferguson. No questions?

Ms. Hooley.

Ms. HOOLEY. Thank you, Mr. Chair, and thank you for being here to talk about this issue. One of the things you've talked about in your testimony is, it's too soon to tell. At least that's the reoccurring theme that I've heard, it's too soon to tell. Can you give me some inclination as to when would be another appropriate time to have a hearing on this and look at some additional information that we will gather over the next 3 months, 6 months? What kind of timeframe are we talking about?

Ms. UNGER. I'm not sure what Commissioner Hunt's views are, but I would think this is something that we should continue to monitor on an ongoing basis. We absolutely could not have gathered any meaningful information before the 6-month period, which is when we had the roundtable in New York. And then we had our first set of 10Ks since then, well, since the rule was promulgated.

As we continue to look at the information that's being provided and seek the input of the industry, the issuers, the analysts and the investors, we can pinpoint what if anything we can do to improve the rule on an ongoing basis.

Ms. HOOLEY. Well, I think like most rules we enact, no matter what agency or legislation we pass, there's always a shakedown period and a time to look at what have we done right, what have we done wrong, and how do we bring some kind of balance to this whole situation. So I will be anxious not only to finish this hearing

but have another round in another 6 months. Thank you for your testimony.

Ms. UNGER. Thank you.

Chairman BAKER. Thank you, Ms. Hooley.

I again want to make another run at trying to understand where the intent is with Reg FD. The presumption is information ultimately affects valuation. And so that if information is provided equally to all, everyone can make judgments about value simultaneously. But information only becomes material if the disclosure of that information would ultimately affect value. So that in order to avoid a potential penalty or inquiry from the SEC—even the inquiry is sometimes enough to make a corporate executive think twice—the standard now becomes let's not say anything even if it could ultimately disclose information to the investor community that ultimately would affect value, thereby insulating us from action so that the safest approach is to say nothing, even if you have knowledge, for example, that the large contract that will be the basis on which future earnings projections are now based, has just been canceled. Because it doesn't go to solvency of the corporation, it's just another day at work.

If you disclosed it, however, it would have the consequence of a significant—and let's take it both ways. It could be that you haven't announced the new contract that will mean significant run-up in price, or you haven't announced the loss of the contract which would result in a devaluation, but you're doing your job as a CEO if you simply do not disclose the material fact based on your concern that the way in which you disclose it may lead you to some liability.

Am I inside the CEO's head with the proper view of the world? Is that's what's going on?

Ms. UNGER. Well, I think there are a couple of things going on with what you said. One is materiality. What is material information? I think you've pinpointed something that everyone would say is material. But the definition, the case law definition, is what a reasonable investor would want to know.

When you say that it might affect the valuation, I think you're talking about the SAB 99 interpretation. One of the considerations is if it would move the price of the stock, which you obviously can't really know in advance, I think.

When you talk about disclosing that information to an analyst, you can do it in one of two ways post-Reg FD. You can either issue a press release and announce it to the world—you know, announce your earnings call and make it available to the public, and announce it that way. Or, you can tell the analyst, pursuant to a confidentiality agreement where the analyst would then not be able to do anything with that information in terms, I guess, of putting it into the total mix of information.

So in that respect, you don't have the time for the analyst to take that piece of material information and somehow allow management to manage the earnings of the company or to soften the blow of the disclosure of that information. You either have to disclose it pursuant to a confidentiality agreement, which I guess means that it remains non-public, or you have to disclose it to the whole public at once. And the question is, well, what does that do then to the price

of your stock? And is that what management wants to do? Do they want to tell everyone at once or not? But those are your two options basically.

Chairman BAKER. Mr. Hunt, if you were on the other side of the table as a CEO for a corporation sitting in front of your Commission, what would you say to the Commission about your view of how this should function?

Mr. HUNT. Given my view of the rule, Mr. Chairman, I think that I would say that companies have always been under an obligation to disclose either the gain or loss of a company that's going to totally change the financial statement for the next quarter or half-year or year.

Chairman BAKER. But let's move the bar just a little closer in, and instead of something that's a significant financial impact, it would enable you—let's take the positive side. It's a really good contract. It's going to improve your bottom line. It may not double your stock value, but it's going to be an improvement. So somebody may want to trade on that information and benefit from that 4, 5, 6 percent increase, being quite happy with that news. And you don't disclose that.

I don't know of anything in current law that requires you to make that disclosure. And if you choose not to disclose it because you're worried about the mechanism by which you make that information available impairing someone, is that really what we want to be doing?

Mr. HUNT. Well, I think actually there is something in the current law. The Supreme Court case that we based most of our materiality standard on, in addition to Accounting Bulletin 99, which says that if something is material, a reasonable investor would want to know it, and it doesn't necessarily have to move the market, but it has to be something that would change the total mix of information that a reasonable investor would want to know.

Now if the company is putting out a document, a proxy statement, a registration statement, a press release in that time when the new contract comes in, then you might have to make that materiality judgment that it's got to be disclosed in one of those documents.

And I think there's a lot of discussion about Regulation FD perhaps chilling the communication—I know you're going to hear that from the second panel—chilling communication between the issuer and the investment community.

Our information so far—and it's very preliminary—is that some companies are putting out more information, some are putting out less. Some are putting out the same. I recognize that some people could suddenly hide behind FD and say I'm not going to say anything to anybody anymore. But I think we are finding that most people are not reacting to this regulation that way.

Chairman BAKER. Thank you, sir.

Mr. Kanjorski.

Mr. Bentsen, do you want to come back again?

Mr. BENTSEN. Yes. Let me follow up on that, because it also brings up another point I wanted to make in my last round.

First of all, the law requires that public companies have to disclose material items quarterly or registration——

Mr. HUNT. Or even more.

Mr. BENTSEN. Pardon?

Mr. HUNT. We encourage them to disclose material information more often than that. If it happens between quarters, then disclose it.

Mr. BENTSEN. But this argument, and Ms. Unger, in your testimony you raise this I think as one of the reasons of your dissent—that some companies might just choose not to disclose anything.

Now ultimately they're going to have to disclose, though. Even if upon the encouragement of the Securities and Exchange Commission that they don't want to disclose in an interim period, they have to disclose in a registration. They have to disclose in an offering document or they have to disclose in a 10Q or 10K.

And so it's just a question that they wouldn't disclose necessarily in the interim period because they figure they might trip over FD in some way and not conducting simultaneous disclosure to the public. Is that your concern?

Ms. UNGER. The only thing I would add to the disclosure requirements that you just enumerated is the Form 8K which has a number of items that do have to be disclosed intraquarter. And there's Item 5, which covers certain material events. And, without having Regulation SK in front of me, I can't remember exactly what they are. And then there's a change in auditors and things like that.

So we've identified some material information that must be disclosed intraquarter. But you're right. There's still a whole host of information out there that we don't say you have to disclose that might not be disclosed as a result of the fear of repercussions.

Mr. BENTSEN. But what would be the motivation? I mean, first of all, I don't think stock analysts necessarily or market analysts necessarily, I mean, they're a conduit of information, but they basically are not a conduit from the standpoint of Acme Corporation sends them a press release and they publish the press release in their report that they send to their investors. They are an analyst of information, theoretically, and they take that information and make their judgment as to what it means.

But what would be the motivation of someone to only provide information to certain parties in an interim period as opposed to providing it across the spectrum?

Ms. UNGER. Why would companies do that do you mean?

Mr. BENTSEN. What would be their motivation, yes.

Ms. UNGER. I think the concern was that companies would provide the information to curry favor with the analysts so that they would receive good coverage in the research reports. The articulated problem is that they could give the information to the analysts, curry favor in some respects by letting the analyst have that information; and the allegations in some cases were that the analysts would take—the way they'd curry favor is to allow the analyst to have that information and to pass it on to the favored clients, who would trade. Not necessarily the analyst him or herself, but the clients of the firm that the analyst was employed by.

Mr. BENTSEN. And why would we want anybody to do that?

Ms. UNGER. I think everyone in the room would agree that's not a good thing. The question is, how do you get at that problem? And

that's a problem of insider trading, but not the type of insider trading to come within the traditional articulation of the rule.

Mr. BENTSEN. I'm not a lawyer, but I think what the court said, there was no trust, whether legal or illicit——

Ms. UNGER. No duty.

Mr. BENTSEN. ——that would cause some sort of insider trading activity. And I don't want to use this term, but I guess I can't think of another one. There is the potential for manipulation, which we would call "spin" in Washington, to say that we're going to provide to some analysts that we want to curry favor with or we want to make something sound a little bit better than it might be, I mean, why not provide it to everyone?

Now I assume that if you were a company that had very good news—and companies seem to do this all the time—you'd want to put it out to the world because you hope it would pump your stock price.

But I guess, you know, this is maybe the devil's advocate to my friend from Louisiana's question. But why would this—I mean, if this chill—I don't understand why this would chill communications between public companies and analysts who follow their stock or follow their companies. And why would we be concerned that that might happen when at the same time the law is pretty specific that the companies have to provide the vast majority of this information?

Ms. UNGER. Well, companies have always been allowed to give information previously. You could provide information to the analysts, and it wasn't a violation of anything, even if it was material non-public information. And frankly, because of the case law, that was true even if the analysts passed that information onto someone else who traded. Well, people thought it certainly presented an appearance problem—that a company could pass material non-public information onto an analyst who could then pass that information on to clients who trade.

That's the problem. Not having material non-public information. That has never been a violation before. You could always possess the information. You could have it and the rule was always you had to disclose it or abstain from trading. Now we're saying the company can't give you that information unless there's a confidentiality agreement or the company discloses that information to the investing public.

Mr. BENTSEN. With the Chairman's indulgence.

Mr. HUNT. Mr. Congressman, if I could add something. In the post-promulgation era, I am not concerned about companies spreading the word of positive information. They're always going to have a reason to do that. I'm concerned about whether there would be any chill on giving out negative information. Not that you won a big contract, but that you lost a big contract.

Mr. BENTSEN. Right.

Mr. HUNT. And that under FD, the company will decide, I'm not going to say anything until I have to in a 10K or something like that, but I'm not going to say it right now. They'll always find a way to get the positive news out to the investment community.

Mr. BENTSEN. And that's a fair point, but it has to be clear for the record that there are very limited periods of time in which they are shielded from having to disclose that information.

Mr. HUNT. But the market can move instantaneously.

Mr. BENTSEN. I understand that also. But the other thing, the point is, you are giving information, again, you're giving information to an analyst and the analyst is not, she is not just taking that information and reprinting it and putting it out under the name of, you know, Bentsen Securities or whatever. It is something that they are taking that information and they are theoretically putting out their own interpretation of that information. They are adding value to that information.

Mr. HUNT. It depends on who you talk to, Mr. Congressman.

Mr. BENTSEN. I understand. But that's the theory of the job. And the question is, so why—I mean, even if you want to curry favor with the analyst and give them the information, I mean, why wouldn't you do that because you know that they're going to—if it's an analyst who happens to like your company, then maybe they're going to put something out saying the fact that they lost that contract isn't all that bad because of all these other things that are going on, and so forth, and so forth. And you have to put it out to everybody else.

I mean, I still don't understand why we would want to protect one specific group as a conduit for information, good or bad, as opposed to opening it up to everyone else. Because that one specific conduit puts their own spin on it theoretically.

Mr. HUNT. Well, I think the theory behind the rule as articulated is that there was a perception that the information, good or bad, was being given to a small group, maybe only one analyst who follows the registrant, the issuer, and that that analyst would pass it onto his or her favored customers, and those favored customers would be able to successfully trade on the basis of that new material information before the rest of the market knew it and could absorb it and trade on it as well.

And so the disadvantage we saw in the existing state of the law, that there might be a time period between which there wasn't any obligation to disclose because it wasn't time for a 10K or you had so much time before you put it in an 8K. And so if it was given to a small number of investors, they would have the advantage over the marketplace in their knowledge both of the information from the issuer and from the analysis that the analyst did before passing it on.

Mr. BENTSEN. And nobody would want that to happen?

Mr. HUNT. No, I would hope not.

Mr. BENTSEN. But in your opinion, will FD help preclude something like that happening?

Mr. HUNT. We hope FD will preclude some people having an information advantage over other people in the market. We know I think realistically that you can never completely level the playing field. Some people are more sophisticated. Some people are more knowledgeable. Some people have more experience in the market. So we're never going to be able to level it completely.

But we hope that this certainly levels it some and helps alleviate the appearance of disadvantage that some people have vis-a-vis other people in the market.

Mr. BENTSEN. And was there any alternative?

Chairman BAKER. Mr. Bentsen, I'm sorry. Your sophistication is taking advantage of the other Members of the subcommittee.

Mr. BENTSEN. I appreciate there are others. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

Mr. Ferguson.

Mr. FERGUSON. Thank you, Mr. Chairman. And I thank the panel for being here. Very briefly, I was not here the whole time. I came in late, so I apologize if this has been covered already. But I just had a quick question for the panel. And I appreciate your patience with us this morning.

My question is why does Reg FD not provide safe harbor for analysts from ensuing liability or derivative liability? I mean, if our goal is transparency, it seems to me that may be one course we'd want to look into. Could you maybe just address that very briefly for me?

Ms. UNGER. Well, Reg FD is a disclosure requirement, and there is no private right of action for a violation of Reg FD. Only the Commission could sue. So if we gave a safe harbor from suit by the Commission, then nobody could sue.

So I'm not sure if that's what you're talking about, or are you talking about the safe harbor for forward-looking projections?

Mr. FERGUSON. It just seems to me if we're trying to promote transparency, we should be looking into many avenues to see what we can do to promote that. So that's why. I just had a question. And again, I apologize I wasn't here the whole time.

Mr. HUNT. Mr. Congressman, I think that we think that—the liability for the analyst is what you asked about—is an extended liability. The rule is mostly aimed at the issuers, the registrant.

There is a possibility, a theoretical possibility of analyst liability if they aid and abet an issuer, for example, in making an unfair disclosure by getting the information and then passing it on to their clients when they know it's material and otherwise nondisclosed information.

So there is a possibility of liability under FD for members of the analyst community, but it's an extended, it's a collateral liability. It's not a direct liability which mostly would rest on the shoulders of issuers and their representatives.

Ms. UNGER. Right. Because it's the company's obligation to make the disclosure.

Mr. FERGUSON. Sure. Thank you. Thanks, Mr. Chairman.

Chairman BAKER. Mr. Ferguson, let me jump in here on this point, though. We are now creating with Reg FD a standard. And if I take action against an issuer based on what I believe to be fraudulent conduct, then I can point to the disparate disclosure standards pursuant to Reg FD as a material fact to substantiate the fraudulent conduct of the corporation.

So I'd think, notwithstanding the fact there are or are not currently pending issues of litigation, certainly this body of law cre-

ates something that a creative attorney can pursue in evidence of a 10(5)(b) violation.

You would I think agree with that observation?

Mr. HUNT. I think creative securities lawyers can always find a way to use whatever information they have.

Chairman BAKER. Depending on the charge per hour, I'm sure.

Mr. HUNT. Yes.

Ms. UNGER. I think we did consider that issue, and there was a concern by the Commission that that would be a problem, that we would somehow inadvertently create the basis or a new basis for a 10(b) claim. In fact, we tried to address that in the adopting release. We stated that a violation of FD would not be the basis for a 10(b) claim.

Chairman BAKER. And to date, we have no knowledge that that in fact has occurred?

Mr. HUNT. No, sir. But I think we would concede that there is certainly a possibility that even though there's no private cause of action under Reg FD itself, it is possible to take something that was said in the FD context, constructed with other things, possibly to make a plausible violation under Section 10(b) or Rule 10(b)(5), but not under Regulation FD in and of itself.

Chairman BAKER. Understood. It's not an actionable cause on its own basis.

Mr. HUNT. Yes, sir.

Chairman BAKER. Mr. Fossella, did you have a question?

Mr. FOSSELLA. Thank you, Mr. Chairman. I apologize for being late, but I have a hearing across the hall on Commerce. I wish I were here for the earlier part of the testimony and questioning. So if I ask a question that's been asked already, accept my apology.

It's been said that Regulation FD has done more harm to small investors as opposed to prior to Reg FD, because the amount of information has actually decreased, and therefore a small investor is not as sophisticated as those who perhaps could engage or contract with analysts or whatever the case might be, are now at a disadvantage prior to the implementation of Regulation FD. Do you agree with that?

Ms. UNGER. I think the focus has been on the quality of information, whether there is good information being disclosed post-FD and that there has been perhaps an increase in the number of disclosures made, but not in what those disclosures are in terms of the actual information provided.

And so the question is whether that's good or bad for the marketplace is I think what you're asking. And that's something that we are monitoring very closely, because obviously that would be a very unintended consequence. If the idea was to provide more information to the marketplace, then certainly it would not be accomplishing that objective if investors were receiving less information.

But I don't know. I don't know that we know other than anecdotally exactly what it's done. And there have been a number of studies in terms of the quality of information, but I think nothing definitive yet.

Mr. HUNT. Yes, sir. I think that clearly the little investor was at a disadvantage, at least a perceived disadvantage, in the pre-FD era when sophisticated, large institutional investors, for example,

could receive information from analysts and trade on that information before the rest of the market knew about it.

If the consequence of Reg FD is there's less information going out to the general investing public now than was going out before, then that's a negative consequence of Regulation FD, and we would have to address that.

As the Chairlady said, of the polls and the surveys that have been done so far in this preliminary 6-month stage, some indicate that more information is going out because of FD, some indicate the same amount of information is going out, and some indicate that issuers are giving out less information.

We're going to have monitor this very closely to see what the overall effect of FD is as to the quantity and quality of information going to the general investing public.

Mr. FOSSELLA. So in a yes or no answer, I guess, you have not drawn a conclusion.

Mr. HUNT. No, sir. We have not drawn it. I think companies and their counsel are still in the learning curve. How do we react to FD, you know? How soon do we get this material information out? Do we judge materiality in the same way we judge offering documents or the proxy material that the companies put out? I think they're in a learning curve. And I'm hopeful that the information will get better in both quantity and quality as we go down the road.

Mr. FOSSELLA. Is there a timeframe in mind at which point you will say, you know what, we're going to assess and realize that perhaps——

Mr. HUNT. We're trying to assess it all the time. We're going to do a study certainly within the next year of the effects of this regulation. We promised at the public hearing where we promulgated it that we would do a study and study its consequences. And, of course, other people whom you will hear from today are also monitoring and doing surveys on the effects of this regulation.

Ms. UNGER. But what's interesting about FD is that the individual investor thinks they love the rule without really knowing what impact it's had on the information. So if you were to poll individual investors, they would say FD is the best thing that ever happened. And the other part of it is, they never thought that it was legal to engage in this type of information dissemination pre-FD.

So you have this perception that FD is a panacea to individual investors without them really understanding the impact it's had on information flow. So I think there would be a very strong reaction from the individual investor community if we were to do something like repeal FD.

So at this point I think maybe we're just trying to improve the effect of the rule.

Mr. FOSSELLA. But doesn't the issuer try to do what's right regardless of what the investor may or may not feel? I'm just trying to get a sense. If those who are correct in saying that Reg FD has had a negative impact on small investors, regardless of what they may feel if asked a question in a poll, if indeed it's wrong or it's been detrimental to the small investor, what is the SEC's position

and when will it make a decision to modify or potentially abolish something like Reg FD?

Ms. UNGER. If I had to answer today whether it's had a negative or a positive impact on information flow, I would say a negative impact on the quality of information and a positive impact on the flow of information generally.

Mr. FOSSELLA. Like it's raining outside? That's more information, but who cares?

Ms. UNGER. Exactly. Exactly. Based on what I've heard and what people have said during the various roundtables, that would be my conclusion.

Mr. HUNT. I'm not ready to reach that conclusion yet. I think clearly there has been more frequent information. I'm not yet ready to make a determination on the quality of information vis-a-vis information that was given out pre-Reg FD.

I mean, one of the contexts to put this in is that there is so much more information about the financial world on TV these days because of all the business networks that, in some ways, the small investors are already inundated with information about what's going on in the marketplace. But I just would withhold the judgment yet on whether the quality of the information has increased or decreased under the FD regime.

Chairman BAKER. Thank you, Mr. Fossella.

Mr. FOSSELLA. Thank you.

Chairman BAKER. I'd like to recess the hearing briefly for the pending vote, but conclude this panel if appropriate. We do have a significant participation in the second panel.

I would express my appreciation to you for your long-standing participation today. No one would have expected the hearing would have gone on quite this long. But in the course of the morning, we've had in excess of 22 Members come in and express an interest in this matter.

It also is a beginning for us, not the end. We will continue our examination of this and related matters throughout the rest of the year and look forward to perhaps when the Commission has reached some preliminary findings, revisiting the issue.

I just recently refinanced, and at the closing had 68 pages of required information. Just the Fannie and Freddie disclosures were 18 pages. And I took the closing agent through a very painful exercise of going through every page, a closing he will not soon forget.

But if I had had 88 pages as opposed to 68, it would not have improved the quality of either of our lives. So I'm not sure that the flow of information is in itself a valuable item. It is more important to have a quality instrument. A one-pager that told me what I needed to know would probably have been a very helpful thing on that morning.

And my concern is that FD, although well-intended, may be turning the firehose on a little heavy and that the quality of the useful result is somewhat questionable, at least in my mind at the moment.

But we are not reaching conclusions here today. We are only trying to understand, and we appreciate your courtesy in participating in the hearing. We'll stand in recess for about 10 minutes.

Mr. HUNT. Thank you, Mr. Chairman.

Ms. UNGER. Thank you, Mr. Chairman.

[Recess.]

Chairman BAKER. I'm reasonably confident there will be Members returning here in a moment. We probably have another hour before we are again interrupted. But I think it appropriate to go ahead and get our second panel initiated.

Few would have predicted we would be starting the second panel at 12:35. So I would express my appreciation to each of you for your participation, make you aware that your statements will be included in the record as received, and would encourage you to summarize your views in order to maximize the ability of Members to be able to ask questions of the panel.

Our first witness in this panel is Mr. James Glassman, Resident Fellow, American Enterprise Institute, and we welcome you, Mr. Glassman. And if we can get you a microphone, I guess we'll get you started. And you do need to pull that thing very close. It's not all that sensitive. So thank you very much, sir.

STATEMENT OF JAMES K. GLASSMAN, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. GLASSMAN. Thank you, Mr. Chairman. It's an honor to be here today to discuss this very important issue.

While the purpose of Executive Regulation FD was to help small investors, it has actually hurt them. Since the regulation was enacted, the volatility of markets has increased, making them scarier places for the public, and increasing the cost of capital for corporations.

The regulation has certainly led to a lower quality of information emanating both from those companies and from the analysts who cover them. Warnings abounded before Reg FD was approved and even advocates admitted that higher volatility was a likely result. For example, in an Op Ed piece in the *New York Times* shortly before the approval of the regulation, Daniel Gross, a supporter of the rule, admitted the obvious. Regulation FD, quote: "will surely bring greater volatility."

Two surveys have now shown that 90 and 71 percent of analysts believe that FD has increased volatility. Obviously, we don't know for sure. There are too many other factors involved. But it stands to reason that FD has increased volatility.

Did the SEC believe that these adverse consequences were simply the price that had to be paid to achieve more important objectives? Fairness, through the elimination of special advantages enjoyed by analysts and professional investors; and objectivity, through the elimination of a system that could reward analysts with access if they gave favorable reports. That seems likely. My own view, however, is that high volatility and degraded information quality have been far too high a price for small investors to pay for a particular vision of fairness promulgated by regulators.

And I speak as someone who has devoted much of his professional life to educating small investors and advocating policies to help them. For nearly 20 years I've been writing about finance and economics, while in recent years I have also served as a Fellow at the American Enterprise Institute in Washington and have run a

website, TechCentralStation.com, that focuses on the nexus among technology, public policy and finance.

My strong belief is that for most Americans, the stock market is the only route to the kind of wealth necessary for a comfortable retirement. So understanding the market and investing wisely are not a luxury, but a necessity.

I have generally applauded the work of the SEC during the tenure of Chairman Arthur Levitt, Jr. Mr. Levitt was my business partner from 1987 to 1993 when we were co-owners of *Roll Call*, the Congressional newspaper that I edited. But at times the Commission's appropriate concern has led to inappropriate policy, mainly because of a lack of faith in free markets and the competitive process. Reg FD is a prime example of a top-down regulatory policy that tries to manage an often messy process which produces better results for small investors.

Is it fair that corporate executives share information with some analysts and not others or with some analysts and not the public at large? Well, fairness is in the eye of the beholder. The Supreme Court in *Dirks* says that fair or not, it is indeed constitutional.

Let me ask a different question. Is it fair that elected officials, including many Members of Congress here today, and certainly even Commissioners of the SEC, share information with selected journalists and not with others, or with some journalists and not the public at large? That would seem to be even less fair than selective sharing by corporate executives since public officials by definition serve the public. Yet selective sharing by politicians happens every day and undoubtedly works not only to promote good policy but also to promote the financial well being of journalists and their publications.

Certainly selective sharing of information by politicians is a way to put more information and analysis into circulation. Without that sharing, the information might not come out at all and might not be understood.

So what is the best way to encourage the dissemination of information, financial information? Not Government rules, but open competition. Competition driven by consumer choice is the key to abundance and variety in the marketplace both of goods and services and of ideas.

Analysts compete. They work to get information about corporations because that information, plus subsequent judgments that they draw from it, gives them an edge over other analysts. As my colleague, Kevin Hassett, an economist at the American Enterprise Institute, has written, "Analysts do this hard work because they or their firm's clients will profit if they are a little bit smarter than the next guy."

It is the potentially asymmetrical nature of the distribution of information that triggers the competition from which all investors benefit, whether they are clients of the analysts with the initial edge or not. If information by law is relayed to all analysts and in fact to all citizens at the same time and in the same way, then the incentive for hard work by analysts declines sharply. Less information comes out, and small investors suffer.

Now while the internet offers the technology to make vast amounts of information about companies available to investors, the

role of analysts remains critical. Raw numbers don't help most investors who have a hard time telling an income statement from a balance sheet. More than ever they need analysts to analyze, to tell them what the numbers mean and to ask corporate managers to find out.

In addition, according to several surveys, Regulation FD has led skittish companies simply to disclose less information. With information limited by this regulation, investors have often been shocked, for example, by quarterly earnings results about which they may have learned in a more gradual, less abrupt way in the preceding months. These shocks almost certainly led to increased volatility and high volatility led small investors especially to make poor decisions about the stocks they hold and may acquire.

Also, press releases and earnings announcements present information in a less contextual manner in a post-FD world.

So what should be done about Regulation FD? Don't study it for 2 years, as has been just suggested earlier, and in fact, don't even fix it, as many issuers and securities industry officials have argued. Abolish it.

Regulation FD is simply the latest manifestation of an approach to regulation that is harmful to consumers, because it denies them the benefits of free market competition. Just as companies compete for the favor of customers they will, given the chance, compete for the favor of investment analysts, their clients and investors at large. How? In part by trying to gain an edge on competitors by offering what analysts and investors want most: Information.

A company that can be relied on for timely, abundant and thorough business data placed in a truthful context is a company that will attract more capital, all else being equal. Investors don't like being kept in the dark. And for that reason, 83 percent of companies now conduct conference calls and four-fifths of them open those calls to the public. We don't need regulators telling companies how to do what is in their best interest.

What Regulation FD reveals, in conclusion, is a misguided, often destructive regulatory mentality. The hubristic notion that regulators stand between investors and chaos, that is simply untrue. Orderly markets in goods and services flourish without the heavy hand of regulation about disclosure. Markets in financial information, given half a chance, will do the same.

Thank you.

[The prepared statement of James K. Glassman can be found on page 83 in the appendix.]

Chairman BAKER. Thank you, Mr. Glassman.

Our next witness is Mr. Perry Boyle, Chief Financial Officer and Deputy Director of Research for the Thomas Weisel Partnership. Mr. Boyle.

STATEMENT OF H. PERRY BOYLE, JR., CFA, DEPUTY DIRECTOR OF RESEARCH, THOMAS WEISEL PARTNERS, LLC

Mr. BOYLE. Thank you. I appreciate the opportunity to convey my views on Reg FD to the subcommittee. My name is Perry Boyle. To correct the record, I'm not the Chief Financial Officer, but I am a founding partner of Thomas Weisel Partners and currently serve as the Deputy Director of Research. I've been an equity analyst

since the middle of 1992, covering a variety of sectors, starting with transportation stocks, business services stocks, and most recently, marketing services stocks. And I think I'm one of the few analysts that the Commission has actually talked to directly on this subject.

To clarify my general position on Reg FD—and I believe you can view me as a typical analyst in this—I support the same ends as the Commission on selective disclosure. Good analysts do favor a system that provides broad, nondiscriminatory dissemination of quality information.

I also note that from a sell-side position, Reg FD, by reducing the flow of quality information, increases the value of good analysts in the marketplace, so it would be disingenuous of me to rail against the regulation despite how strongly I agree with Mr. Glassman in principle.

However, from a public policy perspective, the regulation does have costs that have not been adequately quantified, and it's questionable whether the benefits of the regulation merit those costs.

I listened appreciatively to the Commissioners' plans to study and measure the costs, but I'm still relatively clueless on what they actually plan to study and measure.

I'd like to address some of the questions posed by the Committee in its letter inviting me to testify. First, whether there was a need for Regulation Fair Disclosure prior to its promulgation. I don't believe there was.

It's always been my understanding that selective disclosure was impermissible prior to Reg FD, and one might interpret FD as a rather inarticulate rewrite of previous law that's created much confusion and very little clarity. I don't recall reading in the popular press a groundswell of public demand for a new Fair Disclosure regulation until the SEC raised the issue. The U.S. capital markets are globally recognized as the freest and fairest in the world. Issuers from around the globe flock to our market.

Indeed, I doubt that the vast majority of America's 90 million investors even know about the rule or have any practical use for it, given that almost all of them depend on professionals such as fund managers or stockbrokers to manage the bulk of their accounts.

On the plus side, to the degree that Reg FD has raised public confidence in the capital markets, that would be laudatory. I've seen no study that supports that conclusion. But a reasonable person might presume that that is the case.

From an analyst's perspective, Reg FD does not change our fundamental role, nor does it introduce a new moral or ethical duty on selective dissemination. But it does create more uncertainty about what the definitions surrounding selective dissemination are and how companies and analysts will be prosecuted for sharing information. It has injected uncertainty in the marketplace with an unreasonable definition of materiality and a lack of clarity on how the rule will be applied and enforced.

As a general rule, most of us involved in the capital markets believe that regulations that encourage efficient markets are good, and regulations that impede market efficiency are not good. This is based on our education and experience that over time, securities prices reflect all available information about that security.

In that context, the short-term impact of Reg FD in my experience has been to reduce the flow of useful information from issuers to the investment community. Longer term, as we all learn how to live with it, the restrictive impact is likely to abate. In the information age, with the plethora of media channels, it's hard to keep the lid on interesting news.

Now that the Commission has dealt with the fair disclosure issue, perhaps the next priority should be more on full disclosure. In the normal course of filings under SEC regulations usually generally accepted accounting principles, issuers exclude massive amounts of information that could be presumed material in making an informed investment decision about a company.

The simple fact is that investors will always be making investment decisions based on a combination of imperfect information, varying degrees of analysis, experience, intuition and luck. That's what makes a market.

I think it's instructive to look at who wins and who loses under the regulation. Winners include previous SEC commissioners for a positive public relations move, lawyers engaged by issuers to ensure compliance with the regulation, investor relations and public relations personnel who have much more work to do, the members of the public who were concerned about fairness of information disclosure, the financial media who have more press releases to make sound bites of, the business wires and webcast service companies, day traders who have more press releases to trade off of, market makers, who actually benefit from increased volatility, and good analysts, who have always cultivated a variety of sources of information other than top management of issuers.

Losers include issuers and their shareholders who have to bear the cost of the compliance, investors, who bear the cost of increased market volatility, which I do believe can be measured, and bad analysts, who merely reported what they heard from management.

Contrary to some of the rhetoric we heard this morning, analysts are generally prohibited from short-term trading in the stocks that they cover. Trading activity in advance of anticipated announcements of earnings, which often you see spikes in volume, are people making educated bets, not necessarily on inside information held by analysts. And I would like to see the SEC's data on their concerns on that.

My concern is that Reg FD was designed to attack anecdotes of insider trading rather than attack a documented problem.

Also to Commissioner Hunt's concern. We do not dole out information to select clients. That is prohibited by any number of rules. All our clients get it at the same time. I believe the SEC may not have a very rich view of the role of the analyst. While I'm certainly not asking for sympathy, there are only three things that I know every day when I go to work: First, I'm wrong. If I was right all the time, I wouldn't be doing sell-side research, I'd be talking to you ship-to-shore.

Secondly—I'm going to upset somebody today—I'm paid to have an opinion. Often that opinion will be contrary to the opinion of others, including my clients, which can be upsetting to them. If I don't have an opinion, I'm not doing my job.

And third, I'll be lied to all day by just about everybody I talk to, especially the management teams of the companies I cover.

Our job is to anticipate trends and figure out which companies will capitalize on those trends to the benefits of their shareholders over the long period of time. By reducing the information flow available to the analyst community through poor definitions of materiality and liability, with few safe harbors for the analyst community, the value of the analyst community, which the SEC itself recognizes is necessary to the preservation of a healthy market, is diminished.

How are those affected by FD, adjusting to Reg FD regime in terms of policies, practices and trends? On the positive side, it's created a renewed commitment to what we call primary research. That's where we gather input from customers, vendors, competitors, employees, and so forth, to create a mosaic of information regarding a company's prospects.

On the negative side, it's increased an adversarial relationship between management and analysts. Many issuers now believe that they need to protect themselves from analyst interactions. Many issuers are not particularly happy that analysts are poking more deeply into their relationships with customers, suppliers and even their lower-level employees, but that's a fact of life they need to learn to live with.

Not all of those sources, though, can replace the lost quality of information that was often available from direct interactions with top management, particularly surrounding longer-term strategies and estimate guidance.

In the post-Reg FD world, analyst interaction with top management is far more likely to occur in a highly scripted manner with management's only discussing information that has been scrubbed and sanitized by lawyers and investor relations personnel. These interactions lack spontaneity and a depth of color that existed pre-Reg FD.

There have been numerous articles on Reg FD in recent media, including a May 11th article on page C–1 of the *Wall Street Journal* talking about the Progressive Company and lauding the fact that post-Reg FD, they're now publishing operating statistics on a monthly basis instead of only quarter end. Well, that's clearly positive.

But prior to Reg FD, many companies in a variety of industries already released monthly operating data, and still the data provided by Progressive is historical in nature. They still refuse to give forward guidance on how they believe the company will perform.

The same article notes that Gillette announced earlier this year that it would no longer provide short-term earnings guidance. And a *New York Times* article last Saturday talked about how Wal-Mart will no longer share its detailed sales data with third parties.

The April issue of *CFO Magazine* has a survey done by Thompson Financial. In response to the question, "What changes have you made due to Reg FD?", 21 percent of respondents said they provide more info on earnings and releases. But 21 percent also say they no longer give earnings guidance. Thirty-two percent say that they have limited the flow of information, and 22 percent say they are more cautious in discussing earnings estimates.

The key problem with the regulation is the lack of clarity on what is material versus what is not. In the absence of that clarity and with a new degree of liability, many issuers have chosen to take the safe road of reducing the flow of quality information. So while the regulation may have had positive impact on fairness of information dissemination, it's had a negative impact on the fullness of information dissemination.

I could go through a litany of examples here, but I'm just going to pick one. Post-Reg FD, many issuers will refuse to comment in any way on an analyst's report prior to publication. That's a common but not universal practice for an analyst to send a preview copy to an issuer. The intent is not to have the issuer rewrite the report but rather to comment on factual errors and to rebut any unflattering arguments made by the analyst. It's a courtesy.

On the SEC's website, item number seven on the phone supplement page, "Can an issue ever review and comment on analyst's model privately without triggering Reg FD's disclosure requirements?" And I quote, "Yes. It depends on whether in so doing the issuer communicates material non-public information."

In the interest of time, I'm just going to get to the bottom line. "It would not violate Regulation FD to reveal this type of data even if, when added to the analyst's own font of knowledge, it is used to construct his or her ultimate judgment about the issuer. An issuer may not, however, use the discussion of an analyst's model as a vehicle for selectively communicating either expressly or in code material non-public information."

I would posit that it's impossible for an issuer to determine what the Commission means by "seemingly inconsequential data" in that section, and the last two sections of that guidance are clearly contradictory. So when in doubt, say nothing. So analysts lack the nuance and color they may have previously gotten.

On the issue of volatility, I believe that in addition to the cost of compliance, the primary cost of the regulation has been increased volatility in the market. I disagree with observers who state that that cannot be measured.

Chairman BAKER. Mr. Boyle, if you can, begin to wrap up for me, please.

Mr. BOYLE. OK. It can be, if you look at the CBO Volatility Index or VIX, it clearly indicates an increase in market volatility since the introduction of the prospects of Reg FD early last summer.

I'll skip to how can the regulation be improved, materiality and liability.

Materiality. In general, reducing liability for disseminating information should improve the quality of information disseminated. Therefore, clarification of the definition on materiality would be helpful.

Also, on enforcement, it's unclear to how the regulation will be enforced. While the Commissioners state that they're not looking to enforce it, at the same time they have six ongoing investigations, and actions do speak louder than words. I believe there should be the same kind of safe harbor for security analysts as there are for representatives of the media under Reg FD. The burden should be on the issuer and not on the analyst.

With that, I'll wrap up. Thanks.

[The prepared statement of H. Perry Boyle Jr. can be found on page 93 in the appendix.]

Chairman BAKER. Thank you, Mr. Boyle.

Our next witness is Mr. Thomas Gardner, Co-Founder—and I'm very careful in making the introduction, Mr. Gardner, to say you're Co-Founder of The Motley Fool, making no inference at all. Thank you. Welcome.

STATEMENT OF THOMAS M. GARDNER, CO-FOUNDER, THE MOTLEY FOOL, INC.

Mr. GARDNER. Thank you. Good morning. It's a pleasure to be before the subcommittee to talk about what equal access to information means to all investors. My name is Tom Gardner. I'm Co-Founder of The Motley Fool, and a fool myself.

The Motley Fool is a multimedia personal finance company headquartered across the river in Old Town, Alexandria, Virginia. Our business was founded upon and is driven by the belief that average people can and do benefit from taking a more active interest in the management of their money.

However, before individuals take control over these matters, they need education, they need information, they need an opportunity for dialogue, and they need an open platform for their questions and for answers. And that's where we come in. We teach people the fundamentals of long-term financial management. We help them find the resources they need to budget, save and invest, and we provide a forum for a thriving online community. Our services today reach more than 20 million investors each month.

I am not here, however, as a business owner. I'm here because The Motley Fool represents a vibrant, powerful community of individual investors who go to work, who earn money, and who make decisions about the financial path that their lives will take.

Over the past 8 years we've heard from them again and again about the importance of access to simple information, whether that's information about Einstein's miracle of compounding growth, information about the real after-fee and after-tax returns of managed mutual funds, information about any public company's quarterly earning result, and for investors, access to information means that in a public market this information must be available to all investors at the same time.

Every day, millions of investors put their money in the stock market and become part-owners of companies and businesses that they believe in. Over the last 100 years, the stock market has been the best place for long-term investment, returning average annual returns of around 11 percent, returns that have allowed us to put downpayments on homes, to pay for our kids' educations, to retire comfortably. And along the way, this public market has financed some pretty impressive businesses and led to the creation of products that have changed our lives.

A company like Johnson & Johnson improves the lives of millions of people each year and has done so for more than 100 years, due in large part to its access to capital in the public markets.

The problem, however, is that selective disclosure is threatening the public market system in the U.S. and has been for years. Through selective disclosure, professional investors on Wall Street

have increasingly tried to turn the public markets into private markets of information that benefit themselves and their firms. The net result of this is that smaller investors reduce their investments. Thinking that the game is rigged, they pull back or simply move into index funds and pay fees to mutual fund managers because they feel they have no other option.

They recognize that selective disclosure leads to investing, if it is investing, that is not based on analysis, that is not based on hard work and intelligence, but instead on who you know or how much money you have to invest—the very things that compel public companies and have in the past to privately, illegally share privileged information with select investors and analysts.

If we were establishing a capital market system today from scratch, I think we'd all agree that we'd want to make sure that the soccer mom who's putting $100 a month into a divided reinvestment plan for her child's college education would have access to the same information at the same time as the fund manager wearing a nice suit, carrying a bottle of Mylanta, the guy who has to decide or the gal who has to decide where to put his or her million dollars of the fund. I can't imagine wanting any sort of other public market in a free country.

Selective disclosure, a common practice on Wall Street for years, is a direct violation of the spirit and the law of our public markets, and it undermines equal access. It's a violation that should be of the highest concern to those who oversee the market, the SEC and the U.S. Congress.

In creating the SEC, Congress mandated that the SEC protect investors. Under this mandate, the SEC is obliged to protect all investors—tech investors in Silicon Valley, long-term investors in Omaha, Nebraska, the small business owner that invests from Port Allen, Louisiana, as well as investors on Wall Street. Any SEC action that contravenes this duty would naturally force us to ask why American citizens would pay tax money to fund a regulatory agency that might not protect those citizens' best interests.

Let's talk specifically about Regulation FD. Regulation FD dramatically changed the financial landscape by making information available to all investors simultaneously. Those who oppose Regulation FD are not fighting it based on its fairness. Regulation FD is not Regulation Full Disclosure, it is Regulation Fair Disclosure. The criticisms do not come from those who think it is unfair. That's precisely the problem. It is fair. It promotes fairness. And thus it undermines Wall Street's unfair advantage. And that unfairness is an enormous commercial advantage to the big investment firms on Wall Street, which I have to say—and controversy is part of the game—the SIA and other organizations are funded to protect that commercial interest.

Let's consider some of the arguments specifically noting, as I believe it was noted yesterday, that many of the complaints are supported by studies carried out by those who object to Regulation Full Disclosure.

First, as an individual investor, I am taken aback by the implication that I'm not smart enough to flesh out the information; that I need someone else's help. To claim or even imply that individual investors need interpreters takes us back to the Middle Ages, back

before we had printing presses, when common folks were forced to rely on experts and aristocrats to interpret texts like the Bible for them. They were not permitted for a number of years after the printing press even to have a Bible on their bedside table or any other textbook.

Similarly, the internet now allows individual investors to access, analyze and act on financial information. I certainly don't see a need for a professional investors to earn an illegal information advantage in order to then translate that information on delay for the rest of the marketplace.

Second, the evidence indicates that this claim of analyst objectivity simply isn't true. We know that analysts are not objective sources for individual investors. They work for commercial firms that broadly seek underwriting deals with public companies, and that renders them very subjective players in the context of the public markets. That's the main reason that *Forbes Magazine*, in an article earlier this year, reported that only 1 percent of all analysts' recommendations from sell-side analysts last year were sell recommendations.

While we're talking about analysts, I'd like to know exactly what an analyst is and why I, as an individual investor, can't call myself one. Who determines which analysts without Regulation FD get to sit on illegally exclusive quarterly conference calls? Who determines which analysts get to gain access to private, illegal closed-door meetings with company executives? Who determines which analysts get unlawful earnings guidance from CFOs directly before the general public hears of them? I would like to know that, because if the SEC is not going to enforce Regulation FD or is going to repeal it, I can tell you that I and tens of millions of other American investors would officially like to sign up to become analysts.

If we don't have Regulation FD, we should eliminate all insider trading laws. We should pursue a perfectly free competitive market and have no insider trading laws whatsoever and allow me, along with everyone else, to try and play golf with company insiders so that we can get information and trade in advance of the rest of the marketplace.

What about the claim of stock market volatility? Opponents of Regulation FD will argue that it has increased stock market volatility. I don't think that there's any clear evidence that this exists. If a company, however, releases bad news simultaneously to everyone—and I suggest in this example, let's really look at the volatility studies before we just accept them.

If a company releases bad news simultaneously to everyone and its stock falls from $30 a share to $25 a share, is this any more volatile than if the company selectively releases information to professionals on Wall Street, the stock falls from $30 to $27, then the information gets released to the general public, who sells it down to $25. If we're going to accept volatility studies, we have to keep our eyes focused on the time periods that are being studied.

Finally, opponents of full disclosure will also argue that Regulation FD has somehow stifled corporate disclosure. Let's be clear. It has chilled the distribution of illegal communication of privileged information in a public market. Last week's *Wall Street Journal* reported that Progressive Insurance plans to distribute information

monthly. Progressive's CFO saw Regulation FD as an opportunity for us to open up more to investors.

But even if Regulation FD stifles the flow of information, would we want more information in a public market if that information were protected for a privileged group of Wall Street investors? In a free country, which sort of public market would operate more effectively, one with less information delivered fairly, or one with more information delivered illegally?

Regulation FD is Regulation Fair Disclosure not Full Disclosure. The aim is fairness of distribution of information, not the quality or the quantity of that information.

I'd like to close by praising the SEC for having brought this issue and created policy on it. I'd like to praise the subcommittee for having conversations about it. And I call on Congress and the SEC to enforce Regulation Full Disclosure or to strike it from the record. Let's not do either/or. Let's either enforce it or let's eliminate it so that every investor knows what sort of marketplace we operate in.

I'll close with SEC Chairman Arthur Levitt's quotation which explains why he believes that preserving the public nature of our markets is extremely important to the integrity, confidence and efficiency of those markets. Chairman Levitt said: "Simply put, the practices of selective disclosure defy the principles of integrity and fairness. We teach our children that a person gets ahead through hard work and diligence, that through equal opportunity, everyone has a chance to succeed. America's marketplace should be no exception to that principle. Instead, it should serve as its beacon."

I couldn't agree with Chairman Levitt any more, nor could I agree any more with Warren Buffet. And I guess I will close with Warren Buffet's quote about Regulation Full Disclosure: "The fact that this reform came about because of coercion rather than conscience should be a matter of shame for CEOs and their investor relations departments." It's good to see that the greatest investor in American history is a supporter of fair disclosure.

Thank you for having me today.

[The prepared statement of Thomas M. Gardner can be found on page 101 in the appendix.]

Chairman BAKER. Thank you, sir.

Our next witness is Mr. Patrick Sweeney, General Counsel of Nomura Corporate Research and Asset Management. Welcome, Mr. Sweeney.

STATEMENT OF PATRICK D. SWEENEY, GENERAL COUNSEL, NOMURA CORPORATE RESEARCH AND ASSET MANAGEMENT, INC.

Mr. SWEENEY. Good afternoon, Chairman Baker, Ranking Member Kanjorski and Members of the subcommittee.

Chairman BAKER. And if you would pull that a little bit closer, we can hear you better.

Mr. SWEENEY. My name is Pat Sweeney. I am the General Counsel of Nomura Corporate Research and Asset Management, which is more commonly known as NCRAM. NCRAM is a registered investment adviser and a member of the Investment Company Institute.

NCRAM's clients are mutual funds organized and sold to retail investors in the United States and other major capital markets. While mutual funds themselves are correctly viewed as institutional investors, they are typically offered to the public retail investor markets and draw capital investments from millions of retail investors.

Like many other buy-side investment managers, NCRAM employs its own team of research analysts to support all investment decisions made on behalf of its advisory clients. NCRAM continually engages in a fundamental analysis of the business and financial risk of each corporate issuer in which it has invested or proposes to invest.

As part of this fundamental analysis, NCRAM evaluates the issuer's management experience, market position, cost structure, historical track record and cashflow generating ability.

This process involves not only a review of the company's published financial information, but also incorporates one-on-one visits with company management, discussions with industry analysts, visits to company facilities and consultation with third-party experts as appropriate.

The protocols of investor relations communications between corporate issuers and buy-side investment managers have been carefully structured over the years to limit communications to nonmaterial information which can be used by buy-side analysts to structure proprietary investment models for corporate issuers. This practice is consistent with the long-recognized mosaic theory which enables an investment manager to develop and implement independent investment decisions based upon its analysis of discrete, nonmaterial pieces of information provided by the corporate issuer.

The ability of NCRAM and of many other buy-side investment managers to conduct fundamental investment analysis is a key variable in the quality of investment services provided to retail investors in mutual fund advisory accounts. Fundamental analysis on behalf of mutual funds provides a significant investment benefit which most retail investors would be unable to achieve with their own resources.

And it's from these perspectives that I'm pleased to have the opportunity today to make the following comments on Reg FD. First, a widespread, ongoing practice of selective disclosure of material information by corporate issuers would in fact erode public confidence in the fairness of the securities markets and should be corrected by an appropriate regulatory response.

Second, the broad scope of Reg FD is premised upon the existence of widespread and abusive selective disclosure of material information by corporate issuers.

Third, in assessing whether Reg FD appropriately responds to the problem of abusive selective disclosure, consideration should be given to the potentially adverse impact of the regulation upon the fundamental analysis conducted by buy-side investment managers.

Fourth, by persistently linking the rationale and methodology of Reg FD to insider trading concepts, the Commission appears to have provoked a conservative and overly cautious response on the part of corporate issuers to regulatory compliance.

Fifth, Reg FD has already affected the quantity and timeliness of information provided by corporate issuers, and the adverse impact of the regulation on the fundamental analysis process may progressively worsen as analytical investment models become outdated.

Sixth, the negative impact of Reg FD on market transparency is most apparent in the case of financially stressed or distressed corporate issuers which frequently cite Reg FD restrictions in refusing to respond to demands for accountability by investment managers.

I'd like to close my statement today with two recommendations. First, Reg FD should be re-evaluated generally, taking into account whatever empirical data may be obtained in determining the scope of the selective disclosure problem, as well as the potential detrimental impact of the regulation on the buy-side fundamental analysis process and other legitimate market processes.

And second, public disclosure requirements imposed on corporate issuers by Reg FD should be based upon the objective, itemized reporting methodology of Section 13 of the Securities and Exchange Act, rather than upon subjective and ambiguous determinations of materiality similar to those employed in determining liability for insider trading under Rule 10(b)(5).

NCRAM has appreciated this opportunity to testify before the subcommittee.

[The prepared statement of Patrick D. Sweeney can be found on page 111 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Sweeney.

Our next participant is Mr. Daniel Hann, Senior Vice President and General Counsel, Biomet. Welcome, sir.

STATEMENT OF DANIEL P. HANN, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, BIOMET, INC., WARSAW, IN; ON BEHALF OF THE ASSOCIATION OF PUBLICLY TRADED COMPANIES

Mr. HANN. Thank you. Good afternoon, Chairman Baker, Ranking Member Kanjorski, and Members of the subcommittee. Thank you for the opportunity to testify today on behalf of hundreds of mid-cap and small-cap companies that make up the Association of Publicly Traded Companies. I am Daniel Hann, Senior Vice President and General Counsel of Biomet.

Biomet is in the business of manufacturing and marketing medical devices used primarily by orthopedic surgeons and is headquartered in the industrial heartland of northern Indiana. Biomet has been a member of APTC for many years, and our President and CEO, Dr. Dane Miller, who was recently recognized as one of the top five CEOs in the country for delivering shareholder value, serves on the board of APTC.

The APTC's position on the specific issues before the subcommittee is guided by a belief that issuers, investors and all market participants benefit from governmental policies that are designed to maximize the flow of quality information to the capital markets.

Last month I had the opportunity to participate in the Reg FD roundtable held by the Commission in New York City. The APTC applauds the efforts of Acting Chairman Unger and the other Com-

missioners to understand the full impact of Reg FD and their willingness to provide guidance to market participants.

As a general matter, the Association views Reg FD as reflecting two policy choices made by the Commission. First, the decision not to create a private right of action was a crucial and essential policy choice for Reg FD, and we commend the Commission for this wise decision.

Second, the Commission decided that the benefits of a more level playing field for information outweighed the possible cost of restricting selective disclosure as it can be argued that any restrictions on the quantity and quality of information could negatively impact the efficiency of the stock markets.

Insofar as Reg FD has some positive aspects for issuers that may offset the additional burden of compliance, we as issuers remain relatively neutral. For investors, however, especially long-term buy-and-hold investors, Reg FD is a mixed bag.

With my remaining time, I will briefly focus on four of the questions posed for today's hearing in Chairman Baker's invitation letter.

First, what impact has Reg FD had on the quantity and quality of information? The overall quantity of information has not changed according to two recent surveys. We believe this is probably true because companies are issuing more press releases as a shield against the risk that a non-public disclosure could prove in hindsight to have been material.

However, we believe that the quality of information has been adversely affected by the requirement for public disclosure of all material information. Such a requirement encourages issuers to limit disclosures to more general information that is less likely to become the basis of a private securities class action lawsuit if the company stock hits a downdraft.

While we are unaware of any effort to measure it, we suspect that the quality of information going to the markets has suffered. I will offer a suggestion later as to how this may be mitigated.

A second question posed by the subcommittee is what particular benefits or problems result from Reg FD? The real benefit of Reg FD inures to the benefit of people like me—namely, lawyers. We now have a rule to reference when we caution others to avoid certain means of communication in disclosing certain types of information. We, the lawyers, are now more important and more necessary than ever in publicly traded companies.

Seriously, the primary problem is one of uncertainty. No company wants to serve as the enforcement test case for Reg FD. While we appreciate the recent statements from the Commission that it will not prosecute good faith mistakes, the vagueness of the materiality standard calls for caution. There is a natural inclination to err on the side of caution pending some clarification as to where the Commission will draw the line on materiality.

A third question I would like to address is whether there are any specific ways to improve Reg FD. We believe it can be improved and offer two suggestions. Our first proposal focuses on the problem that the legal definition of "materiality" is vague and fact-specific. Because materiality is the basis for enforcement, companies are generally responding by providing less information in non-pub-

lic communications and providing more information of a general nature in a more structured public format.

The decline in more specific information probably harms the overall quality of information in the market. The flow of information to the markets might well continue abated despite the new risk of enforcement if the rule were made clear and the risks were more well-defined.

Our second recommendation is that the Commission can promote the flow of information by supporting the statutory safe harbor for forward-looking statements or by promulgating a broader and deeper safe harbor under the authority granted in the Private Securities Litigation Reform Act of 1995.

Companies are now very cautious about making the types of specific forward-looking statements that will be most useful for individual investors. Currently, companies that wish to communicate their expectations about their futures must do so very carefully. Despite reform litigation, private securities class action lawsuits are still quite common.

In addition, the safe harbor for forward-looking statements is still a work in progress by the Federal courts. The commission could be a positive force for improving the quality of forward-looking disclosures if it supported a more expansive interpretation of the safe harbor and acted as a friend of the court.

The commission could also use its statutory authority to create a safe harbor that is clear enough that both issuers and investors can make good use of information.

A final question today deals with how companies are adjusting to Reg FD. Please make no mistake about it, Reg FD has significantly changed the way issuers deal with the investment community. In my experience, issuers have made a bona fide attempt to comply with the new rule. In recent months, issuers have worked very hard to implement new policies and procedures and have taken steps to educate directors, officers and employees as to their respective obligations and duties under the rule.

One consequence of the new rule is that issuer press releases, as we have heard today, tend to be longer and more detailed. Unfortunately, this may make it difficult for the average investor now to separate the wheat from the chaff.

In closing, the APTC believes that with the Commission's continued openness to change and the adoption of the APTC's proposed solutions, there is opportunity to substantially improve Reg FD.

Once again, I would like to thank you for the opportunity to appear before this subcommittee and share the views of the APTC on Reg FD. Thank you.

[The prepared statement of Daniel P. Hann can be found on page 131 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Hann.

Our final witness today is Mr. Stuart Kaswell, Senior Vice President and General Counsel for the Securities Industry Association. Welcome, Mr. Kaswell.

STATEMENT OF STUART J. KASWELL, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, SECURITIES INDUSTRY ASSOCIATION

Mr. KASWELL. Thank you, Mr. Chairman. Chairman Baker, Mr. Kanjorski and Members of the subcommittee. My name is Stuart Kaswell and I am General Counsel of the Securities Industry Association.

With me today is my colleague, Frank Fernandez, SIA's Chief Economist and Director of Research. SIA's nearly 700 member firms are active in all U.S. and foreign markets and account for the overwhelming majority of all securities-related business in North America. About 50 million Americans hold accounts with our firms. SIA commends the subcommittee for holding this hearing. I deeply appreciate the opportunity to testify.

SIA strongly believes that vibrant securities markets require a vigorous flow of information from issuers to the marketplace. We think there is a broad consensus on that simple but important point. The only debate has been over the best means for encouraging that flow of information. Investors and issuers as well as the economy as a whole will suffer if issuers face obstacles in disclosing information.

Regulation FD is a bold experiment in which the SEC has tried to ensure that information flows to the markets on a broad basis. SIA was a critic of the rule. Our principal concern then as now is that the rule would reduce the quality and quantity of information flowing to the markets.

Now that we have had a short period of experience with the rule, we think it is entirely appropriate for this subcommittee to consider whether the rule has had the desired effect.

After the adoption of Regulation FD, SIA undertook a study of the effect of the rule. We interviewed 30 buy- and sell-side analysts, interviewed 25 general counsels of issuers, conducted a random telephone survey of 505 individual investors, and conducted a survey of 94 SIA member firms. Although 6 months is not a lot of time, the results are revealing. We are releasing a copy of that study to the subcommittee today.

SIA's study shows the following. The good news is that Regulation FD has produced a benefit of accelerating the healthy trend toward communicating material information to the public and securities professionals simultaneously. It may also have enhanced the public's perception of the fairness of our markets.

We should note, however, that only 14 percent of investors surveyed seek the information that issuers communicate directly to the public.

Unfortunately, there is also some bad news. The vast majority of analysts feel that the quality of information put out by companies is inferior to the information that reached the market before Regulation FD was adopted. Regulation FD is costing much more to implement than the SEC predicted. These costs include recurring expenses and are not just transitional costs.

Ninety percent of the analysts surveyed believe that Regulation FD contributions to stock price volatility. However, SIA cannot quantify the impact that FD has had on volatility.

In light of these results, SIA wants to work with all interested parties to ensure that the goals of Regulation FD may be more fully realized with fewer side effects.

Let me be clear. We do not seek repeal of Regulation FD. SIA would like to offer ideas that will help ensure a vigorous flow of information from issuers to the markets.

We have two primary suggestions that we believe would be helpful. First, we suggest developing a more concise definition of "materiality" for Regulation FD. The current amorphous definition leaves issuers in a quandary as to whether many facts are material or nonmaterial. A clearer definition under this rule would ease those concerns and encourage more disclosure.

Second, we suggest that persons receiving information should not be subject to derivative liability. A senior member of the SEC staff has said it is OK to be persistent and dogged. It is not OK to be abusive and threatening. The problem is that analysts who seek to probe for information should not be subject to an after-the-fact assessment of whether he or she has crossed the line from persistent to abusive. It is the analyst's job to gather information on behalf of investors. But Regulation FD makes it risky to ask penetrating questions. We do not think that the risk of derivative liability serves investors. Indeed, we think it is counterproductive.

Our written statement expands on these ideas and offers some others as well. SIA appreciates the opportunity to share the results of its study and to offer suggestions for improving Regulation FD.

SIA hopes it can make a positive contribution to this debate and can help ensure that American investors receive the information they need to make good investment decisions, whether they rely on professional analysts or do their own research.

Thank you very much.

[The prepared statement of Stuart J. Kaswell can be found on page 141 in the appendix.]

Chairman BAKER. Thank you, Mr. Kaswell.

For the purposes of a complete record, I have been asked to include a statement provided by the Bond Market Association which will be included as a part of the official record.

[The information referred to can be found on page 160 in the appendix.]

Chairman BAKER. Mr. Sweeney, help me understand a practicality. NCRAM used to do certain things pre-Reg FD that it now does not do. Give me an example of what you would advise corporate management to steer clear of that previously would have been behavior that was not subject to concern.

Mr. SWEENEY. Well, Chairman Baker, it is very difficult to give corporate issuers advice in the context of the current rule because of the uncertainties as to what they can and cannot tell us in the traditional one-on-one interviews.

Those uncertainties to a large extent were compounded by some fairly aggressive language in the SEC's adopting release in which the SEC specifically, and I would say went out of their way, to warn corporate issuers about speaking with securities analysts seeking guidance concerning earnings forecasts.

The SEC stated that whenever 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. With that type of interpretation of the regulation, one can understand how most corporate issuers and their counsel would be extremely conservative about giving any information to a buy-side analyst that the analyst could then apply to his own earnings model.

And what has in fact happened is that although one-on-one calls and group investor calls continue, less information is provided on those calls. Corporate issuers have traditionally assisted buy-side analysts in the construction of investment models for the issuers by providing historic building block components of revenue, expense and margin data, none of which would be considered material nonpublic information at the time the issuer shared it, because it would be historic.

In our experience, a significant number of corporate issuers have either discontinued or curtailed this practice.

Chairman BAKER. Of revenue expenditure and market data? Is that which is now being withheld? That is what I am trying to get to. What is it that executives are being counseled to be very careful in exercising disclosure that previously would not have been?

Mr. SWEENEY. Typically, a buy-side analyst looking at a corporate issuer would construct his own investment model for that issuer on a going-forward basis from many sources—from his analysis of the industry, from macro research input that he might get from the sell-side, but also very critically, in one-on-one discussions and group investor calls with the issuer. Now what the analyst would like to obtain on those calls is not a flat statement or a flat wink in the eye about what the next earnings results are going to be.

What they are expecting to obtain are, for example, segment information from different segments of the company's business; information pertaining to revenues or expense trends in various segments, many times simply on a historic basis, referring, for example, to financial statements that have already been filed with the public on a Form 10K; trying to break them down into greater detail so that for the future, the buy-side analyst can construct his own model to project how this issuer is going to perform in the future. That kind of data is now being withheld.

Chairman BAKER. Wouldn't there be some concern from your perspective when you counsel the CEO to be careful with regard to X, Y and Z and it perhaps has been disclosed in pre-FD era, there may be an attachment of liability for your refusal to disclose it now because you are trying to avert contravention of Reg FD, and it is something that the investor could allege at a later time, had they known, they would have made different judgments about the advisability of the investment?

I mean, no matter which way you go here, isn't there some attachment of liability?

Mr. SWEENEY. Well, there is certainly a lot of concern about liability.

Chairman BAKER. And let's talk about some other company. I certainly wouldn't——

Mr. SWEENEY. There is certainly a lot of concern about liability that is untested at this point. But when you see statements like

the one that I cited in the adopting release, it certainly heightens the concerns of corporate issuers and their counsel.

I do not advise issuers. I am on the buy-side asking for the information.

Chairman BAKER. I get the sense people in the market are sort of waiting for the first victim to be selected to find out just how bad this really is or how good it could be. If materiality is clarified, if the manner in which notice is established as being the way to insulate yourself, perhaps industry executives could find a way to live with FD. But it is the uncertainty of knowing how the rules will be interpreted at the moment that appears to be creating the biggest problem. Is that fair?

Mr. SWEENEY. That is true, Mr. Chairman. And I would also revert back to a comment you made earlier today with Commissioner Unger in your comparison of some earnings releases that caused stock prices to go up and some earnings releases that caused stock prices to go down. Of course, what you left out is that some earnings releases don't affect stock prices at all. And the fact of the matter is, stock price movements in our complex capital markets tend to be the result of many different factors. And it is somewhat difficult to deal with a materiality standard that has been directly tied to the accounting bulletin release that referred to the impact on trading prices. That is, in particular, a very troubling aspect of the interpretation to date.

Chairman BAKER. Yes. The only certainty in the market is if I own it, it's going to go down.

Mr. Kanjorski.

Mr. KANJORSKI. No, I do not agree. It is if I own it, it goes down.

Boy, the six of you have really confused the heck out of me. I was trying to keep score. The only thing I have to ask my friend Mr. Glassman is why do you disagree with your former partner so much? He obviously put this rule together.

Mr. GLASSMAN. Well, he didn't ask me before, you know. I agree with him on many things, and I think he did an excellent job as Chairman, and I think his focus on small investors, educating investors having town meetings and so forth, was excellent. I just think this is a misguided attempt to do something which is admirable but really which is causing much more harm than good.

Mr. KANJORSKI. Do you get the sense—all six of you, whoever wants to pick up on this point—that somebody felt that there was insider trading and tried to fix it, and this regulation is the result? And when I ask, was there that much insider trading that it was a big problem? Was this too much of a fix?

Mr. KASWELL. Mr. Kanjorski, I would argue that Regulation FD is not supposed to be an insider trading remedy. We felt that the SEC had plenty of authority to proceed on the case of Rule 10(b)(5) to go against insider trading. We don't think there is a lot of insider trading out there. But we want the SEC to prosecute those cases vigorously. We argue they had authority.

Regulation FD tries to turn the securities laws into a parity of information standard, because the SEC couldn't proceed on an antifraud theory.

Mr. KANJORSKI. But wouldn't the prior testimony of the Commissioners that they had a perceived insider trading problem suggest this rule was one of the solutions? Yes?

Mr. BOYLE. I agree with what you are saying, Congressman. If insider trading is the aim, Reg FD is not the weapon to address that. And I haven't seen any studies through this process on how big a problem insider trading was to warrant this kind of an issue. And I would say that that the regulations prior to Reg FD were very adequate to address that.

Mr. KANJORSKI. You know, it puts me in a quandary. And, I am not the only one. You are not going to find many politicians up here that aren't going to take a position that we want as much information as possible provided to the public and the best-educated investors. But, I tend to agree with whomever made the statement that a lot of this information really isn't usable and that we probably have a pretty strong free flow of information occurring through the old practices. Moreover, the only reason you would go to this absolute fairness provision is if you felt there was insider trading. But that may not be correct. I appreciate Mr. Gardner's position that you feel this is the best thing since sliced cheese, I assume.

But I am in a quandary that we don't understand enough. We have such a diverse recommendation here from the six witnesses. For instance, Mr. Glassman said not to study it, but just to do away with it. I am not sure we are even in a position to make that conclusion at this time. I appreciate all the testimony, and it clearly sets forth to me that this subcommittee probably has to do a lot more study, Mr. Glassman, before we could decide to do away with it. But, it may eventually warrant that result.

I am just a little sensitive to the new, inventive smaller companies that are coming along. I am worried about the terrible burden we may be putting on them and the cost of getting involved in these sorts of things. It is so nice to have regulations. It is so nice to appear to have absolute fairness. But sometimes economic fairness isn't there because of size, experience and the ability to direct the assets in one way or another.

Can somebody make a compelling argument of something really good and important that has come out of the regulation that should automatically keep us on it? OK, Mr. Gardner.

Mr. GARDNER. Well, I think part of the challenge for the Commission is to hear from individuals. Because the broadest constituency in our public market is the individual investor, whether that is the person in investor club, investment club, somebody managing their own money.

I mean, we have a tremendous collection of bright people out there, and I think, unfortunately, the knee-jerk assumption is that the individual investor is somehow ignorant or can't do this themselves or shouldn't be given the same information, because they will misunderstand that information.

What I think is most laudatory that has come out of Regulation FD is the recognition that there was unfair disclosure of information. And I believe we are in an adjustment period today where there is less information and lower quality information but that over time companies will learn what they can deliver and when they can deliver it.

I simply resubmit that what has really been chilled here is the selective disclosure of information that should be illegal in a public market. We have chilled the distribution of information from a corporate executive to curry favor of an analyst to distribute that information to his clients simultaneously within their firm but not to anyone else.

Mr. KANJORSKI. Mr. Boyle does not look like that kind of guy.

Mr. BOYLE. I wish corporate managements were trying to curry my favor. And I use The Motley Fool site. I think it is a fantastic site. But as the Chairman said earlier, the average investor in the market is $60,000 and only $50,000 of net worth. And you really have to question whether we should be encouraging people to speculate in the market based on those kind of financial standards. And I know you would argue with that.

Second, the sad fact is that most individual investors when trading individual stocks rely on the media for information with very little analysis. And so when you replace the role of an analyst with the role of a talking head who is chosen more for ratings potential than in-depth analysis, you have to question that economic impact on the market and whether the public wins in that situation.

Mr. KANJORSKI. Do I hear the call letters "CNBC" with your comments?

Mr. BOYLE. Well, and then selective dissemination. I would love to hear more from Mr. Gardner on what his analysis of the issue and problem was other than a perception issue, because my experience is that it was the exception rather than the rule and that most analysts are deathly afraid of receiving selective information because they don't want to have the liability for it.

Mr. GARDNER. I would just say that there are so many pieces of evidence pre-Reg FD where you had quarterly conference calls that were exclusive to a privileged group of Wall Street analysts and you would see that stock move in after-hours trading. You would have a quarterly conference call at 5:00 p.m. There would be only 10 analysts allowed on the call, no individual investors allowed on the call, and you would see the stock go up 20 percent or down 20 percent before the market even opened the next day. I don't understand how that could happen unless there was some series of investors operating in the after-hours market that simply did not have access to that but were speculating that that information might have happened on the call.

I think it is pretty clear that the people who were on the call were in some ways participating directly or indirectly, and I think it is far more indirect participation, in the movement of that stock in after-hours.

I mean, the simplest way to look at this that I see is, we may only have one smart individual investor out there. Maybe the rest of them are idiots. All these people out there that are trying to buy stocks are foolish with a small "f". They are relying on the media. They are making all of the old mistakes and they are losing fortunes in front of our eyes.

But if there is one investor out there, a single individual investor that is bright enough, that has the resources, that it is important enough to her to be following an individual company that she is a part-owner of, I believe the law of the public market should protect

that investor's right to get information at the same time as any big Wall Street firm would get it.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Glassman, in your testimony you talk about a free market—that FD takes us away from a free market approach for analysts. But on the other hand, isn't there some form of arbitrage that occurs among analysts, that some analysts are privy to information and other analysts are not? That there is an inefficiency in the marketplace? That an analyst at Solomon Smith Barney may have an in to certain information because of a relationship that an analyst at Merrill may not?

I am not sure that that is completely a free market. And I am not sure that analysts are in part reporters, I guess. But they are also in part editorialists. Because they are providing an analytical viewpoint on data that is available.

Second of all, I am surprised that full disclosure is now somehow perceived as disruptive to the market. That full disclosure of information is somehow bad for the marketplace when I would think you would want in a free and open and competitive marketplace for investors to have as much data as available. What investors do with it and whether they make money or lose money is their problem. But generally, in a free market system, I would think you would want everybody to have access to the same tools.

Mr. GLASSMAN. I think that what you want in a free market system is as much information as possible. And in fact, the journalistic model is a good one. I mean, if the only way the journalist had to get information was the dissemination of press releases, then I don't think that Americans would know as much as they know today because we have a vigorously competitive press, which uses all sorts of means to find things out.

Mr. BENTSEN. But if I could interrupt you for a second. And I have to move through here quickly. But we also know in the press world, and I will use a political analogy, that in some cases, some will give information to the *New York Times* as opposed to the *Wall Street Journal* because they think that they can control the story better through the *New York Times* than they can if they delivered it to everybody in the *Wall Street Journal* and the *LA Times* and everybody else who was dealing with that.

Mr. GLASSMAN. That is exactly right. But that means that there is more information out there. Once the information gets out, and it might not have gotten out at all if it had not been for the selective dissemination of the information, then more journalists get onto it, there is more discussion about it. And that is actually a very good analogy with what is going on here.

It may well be that there is something that is select. I do not believe it should be illegal. But certainly the notion that some analyst gets an edge on another analyst I don't think is bad for the total amount of information that people are gong to get through a system like that. That is what I am saying.

But that is almost an extreme case. Let me just give you one example, because I think we are——

Mr. BENTSEN. If you could hold up for a second, because I want to follow up on that point.

Mr. GLASSMAN. Sure.

Mr. BENTSEN. I understand the presumption that you are making, and there is nothing wrong with that presumption, assuming that it turns out that way. But let me ask Mr. Boyle or Mr. Sweeney, you all prepare analyst reports on corporations that you are following. Maybe Mr. Sweeney in funds, you are doing it differently. Those reports, when you issue a report that says Acme Corp. has lost a big contract and you now have a sell recommendation on it, generally will be picked up in the financial press over time, assuming because you are a watched analyst, let's say.

But do you all, when you publish that report, who do you distribute that report to? Do you distribute it to your clients, or do you put it out available to anybody who wants it? Who gets that report first?

Mr. BOYLE. We write our research for our clients. The way it is distributed is that we have agreements with wire services such as First Call, Multex and others that whenever we make a material change, which is typically to find there is a change in estimates or a change in recommendation or a change in price target on a stock, we will issue what is called a first call note that goes to those wire services.

Most institutional investors are subscribers of those services. We also as a matter of practice—and I believe it is the practice of most investment banks—disseminate the research at that same time to many—it is literally at a push of a button. It goes to all our targeted services. It goes out to our clients, it goes out to these services, and in many cases, it goes to the media as well. We distribute our research to multiple layers in the media: Bloomberg, *Wall Street Journal*, *New York Times*, some websites. There are actually some website aggregators that we provide information to.

And I think if you just went to cbsmarketwatch.com before the open of the market, you would see a whole raft. Morgan Stanley changing estimates on this, Thomas Weisel Partners downgrading that. It gets to the market pretty darn fast.

Mr. BENTSEN. But it is a discretionary action on the part of the analyst or the firm that the analyst is employed by?

Mr. BOYLE. It is a discretion—to provide it to the mass media is a discretionary item, yes.

Mr. BENTSEN. Mr. Sweeney.

Mr. SWEENEY. Yes. If I may respond to that. This highlights one of the major differences between buy-side and sell-side analysts. Buy-side analysts do not issue reports. Buy-side analysts take in information from the company in these one-on-one meetings. They take in information from many sources, analyze it for purposes of refining their investment models for a corporate issuer, and then making an investment decision for their managed accounts, their accounts being the mutual funds that the soccer moms and other retail investors invest in.

So it is a very different dynamic on the receiving end with the buy-side investor.

Mr. BOYLE. I had one important qualification to what I just said. I'm cheating. I'm reading Tom's notes as he's writing them. We are

prohibited from trading for our own account before the notes go out, OK?

Mr. BENTSEN. Right. No, I understand.

Mr. BOYLE. So I just want to make sure that people understand that front running is against the law.

Mr. BENTSEN. No, I understand that. I understand that.

Chairman BAKER. If I may, I would like to get Mr. Fossella in and try to conclude the hearing before we go for this vote. Mr. Fossella.

Mr. FOSSELLA. Thank you, Mr. Chairman. And I guess we can all agree we want to make more Americans investors. The question is, how do we do it as it relates to this regulation?

And one example of how we can draw two different conclusions from the same event, two of you, Mr. Gardner and Mr. Boyle, reference an article that appeared in the *Wall Street Journal* on May 11th regarding Progressive. Mr. Gardner said that Progressive's CFO saw Regulation FD as an opportunity for us to open more to investors.

Mr. Boyle, you sort of said the same thing, but then went on to say Progressive will now issue monthly statistics. This may force its competitors to do the same. Clearly positive. But still the data provided by Progressive is historical. They still refuse to give forward guidance on how they believe the company will perform. And even prior to Reg FD, Progressive had moved toward having quarterly earnings conference calls.

The article also mentions how Progressive is not giving any commentary or analysis on their operating statistics and won't report investment incomes and tax rates. And you further go on to say how in the *New York Times* article how Wal-Mart will no longer share its detailed sales data with third parties.

So I guess my question really is, given that, to Mr. Gardner, it seems that some folks want to abolish FD. Some feel that it has growing pains. Some feel that there is clearly room for improvement, like Mr. Boyle cites materiality and perhaps a carve-out and a safe harbor for analysts. Do you see any room for modifying Reg FD to provide some guidance, for example, on issues like materiality?

Mr. GARDNER. I think that there are opportunities to modify Reg FD. I don't think now is the time to do so, because I don't believe there is enough evidence out there after a 6-month period.

I would say that in the case of Progressive, there are going to be a lot of companies that will make a decision about whether or not to release forward-looking statements, some of them companies that Mr. Buffett supports generally refuse to make forward-looking statements because there is a high level of speculation there that sometimes doesn't come true, and that can come back to bite a company.

So there are different reasons that Progressive would choose to release different pieces of information, but they did state clearly that they support Regulation FD, and this is an action in support of it, and their belief that they should communicate to all investors at the same time.

So in terms of modifications, I think that there are safe harbor opportunities. But I think essentially the one-on-one call that a

buy-side analyst would have, while generally my interests lie with the buy-side analysts. They are doing research to try and figure out how well a company is doing.

But should a buy-side analyst get a timing advantage on the answer to their question to another buy-side analyst who may have less money, be less consequential to the CEO of that company, companies can release this information and answer these questions in public conferences and via press releases, and I think there will be an opportunity to carve out safe harbors within Reg FD to give them that public opportunity to have a more thoroughgoing discussion about their prospects.

Mr. FOSSELLA. Let me throw it out to Mr. Glassman to jump in to respond in a way. What if—I think you were saying that the companies themselves are going to re-engineer and figure out a way to disseminate this information and work within the existing Reg FD, subject to maybe a minor modification. What if they don't? And what if ultimately the unintended consequence is to penalize the person I think you genuinely want to help? What if there is no modification? What if everybody sorts of sits back and holds back material information because they don't have any guidance as to what is material and what isn't? And maybe I will just throw it to Mr. Glassman.

Mr. GLASSMAN. Well, this is already happening. And it's interesting that Mr. Gardner should say that in fact we are getting less, we appear to be getting less good information.

Let me just give you another example. And I think this might be more to the point. On the very day that Reg FD went into effect, the *Wall Street Journal* ran an article about Matthew Burler, a Morgan Stanley Dean Witter analyst, who tried to ask a Georgia-Pacific executive for his usual guidance on Mr. Burler's spreadsheets, which cover—and I know that Mr. Gardner likes to denigrate analysts—but Mr. Burler's spreadsheets cover 887 financial factors regarding the company.

This time, however, he got no help from Georgia-Pacific, which was worried about violating Reg FD. As a result, said Mr. Burler, there is a greater chance for error. Now I cannot see for the life of me how it is beneficial to the average small investor who uses The Motley Fool or any other source that these corporate executives won't even make a comment on a conscientious analyst's spreadsheet of 887 financial factors. And that is a real life example. That is actually what really does go on with analysts.

So there is no doubt that we will get a degradation of information and the quality of information, and that is the reason why I wanted to respond to Congressman Kanjorski. The reason I say don't study it, because, you know, we just heard the SEC say we ought to study it for 2 years. Well, by then, maybe companies won't be able to adapt, as you say, and certainly we will have more volatility.

We already have problems right now. And I think this is not a time to wait another 2 years to do something.

Mr. FOSSELLA. Did you want to add to that at all, Mr. Gardner?

Mr. GARDNER. I don't think it is the Government's responsibility to protect the quantity or the quality of information in the public

markets. I think it is the Government's responsibility to protect the fairness of the marketplace for investors.

So if it means a temporary reduction in the quantity and quality of information as companies determine how they can communicate with all of their owners fairly, simultaneously, it is a tradeoff that I know millions of individual investors are willing to make. And that is in evidence on our site and basically in any forum that individual investors——

Mr. GLASSMAN. Even though, as you know, Tom, it is not just a tradeoff. It basically means higher volatility and a degradation of information, essentially means that the price of stocks will go down as a result. The cost of capital will increase. The price of stocks will go down. And frankly, I don't think that is a tradeoff that most Americans would want to see.

Mr. BOYLE. I would also add that it would be very good for the market makers under that rule. More volatility is good for market makers, bad for investors. And I was actually a little surprised to hear from each according to his abilities to each according to his needs logic there.

Mr. HANN. In that regard, I would add that all the regulation in the world will never level the playing field. And I think that is a point the Commission alluded to this morning. And Chairman Baker, one of your initial questions today was, is this really essentially a misplaced insider trading rule?

This is a disclosure rule, but I think because of the perceived shortcomings of the Dirks decision that the Commission also addressed this morning, we do have a misguided rule, and we have one that is trying to accomplish indirectly what it could not do directly, and that is namely, try to push analysts on the insider trading issue.

Mr. KASWELL. As long as we seem to be running down the line.

Chairman BAKER. Please, if you'd like.

Mr. KASWELL. It seems to me, too, that by punishing analysts for trying to ask the hard questions, if we are going to be in a Regulation FD environment, if an analyst pushes too hard and actually succeeds in getting information, not because he is trying to encourage the issuer to break the law, but just because he is being probing as a good reporter would be probing, that is a good thing for investors that the analyst is representing. And therefore, the analyst should not be subject to a sort of Monday-morning quarterbacking test of whether or not he was too aggressive in that setting.

The other point I would just like to make is putting the full burden on particularly small issuers to ensure that the information they get out, they have that full responsibility. And it isn't, it seems to me that it is easy for a larger corporation to ensure their story is being told, but for a smaller corporation, that puts a very difficult burden on them and perhaps there are other ways to address that by filing a procedural AK.

Chairman BAKER. I want to thank all the members of the panel for your patience and participation. I think it has been a very informative hearing for the Members of the Committee. We have had a significant number of Members in and out during the course of the day.

Suffice it to say, I think there are some areas of concern that have been raised. This is only our first view of the subject. We will take additional action over the coming weeks. We would encourage each of you as you have further thoughts or inclinations to please forward them for the Committee review.

I do have concern that the Dirks holding and the fiduciary responsibility relationship as the trigger for liability has indeed clouded the landscape a bit. And I do think there is general agreement by everyone on the Committee, transparency is a good thing, flow of information is a good thing.

But we don't in the pursuit of transparency and flow of information want to create a new cause of action that apparently is gong to have adverse consequences on the investor being appropriately informed.

So I think we all generally want to pursue the goal. I think we need to do a careful analysis of whether this mechanism is achieving that end, and are there ways perhaps from repeal to modification to taking another look at the whole issue of are there advantaged people in the market who are trading on information to the distress of the smaller, independent investor?

A very difficult subject. Despite admonitions to move today, I suspect we will take a day or two and examine it more thoroughly. But I do want to express my appreciation to all of you for your participation.

Our hearing is adjourned.

[Whereupon, at 2:00 p.m., the hearing was adjourned.]

A P P E N D I X

May 17, 2001

Congressman Joseph Crowley
Remarks - Hearing - Reg FD
May 17, 2001

I want to thank Chairman Baker and Ranking Member Kanjorski for holding this important hearing today on Fair Disclosure and more specifically Reg FD.

Reg FD, one of the hallmark achievements of former SEC Commissioner Arthur Leavitt, was issued to provide both greater investor confidence in our markets as well as ensure the adequate free flow of all necessary information on companies to all of their investors - large or small.

As stock ownership in our nation grows - almost 50% of American households now have some sort of ownership of our markets through mutual funds, 401(k)'s retirement plans and other investment vehicles, we need to maintain and strengthen consumer confidence.

As Chairman Greenspan told this Committee this winter - consumer confidence is one of if not the most important facet to the performance of our economy.

Reg FD has a number of important benefits to our market system.

Stating that, I am pleased to have the opportunity to participate in this hearing, as there may also be valid concerns with some portions of Reg FD - portions that may need to be adjusted to both maintain investor confidence while as providing for the maximum efficiency of our market system.

This regulation is to inform investors-not punish analysts or issuing companies; the goal of this regulation is to increase information, not decrease it.

And the overall goal of this Committee - and the underlying reason for this hearing - is to ensure that we maintain the vital balance between transparency and efficiency in our markets.

Therefore, I again thank the Chairman and Ranking member for conducting this hearing and I look forward to hearing our witnesses.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE IMPLEMENTATION OF THE SECURITIES AND EXCHANGE COMMISSION'S REGULATION FAIR DISCLOSURE

THURSDAY, MAY 17, 2001

Mr. Chairman, thank you for the opportunity to comment briefly before we begin today's hearing on Regulation Fair Disclosure, otherwise known as Reg FD. Designed to end the selective disclosure of material, non-public information, Reg FD seeks to increase informational efficiency and allocational efficiency in our nation's securities markets, thus increasing market integrity and raising investor confidence. Since its adoption, this promising SEC rule to end the problems of asymmetric information has generally attracted praise from investor advocates and criticism from professionals in the securities industry. Publicly traded companies have also found themselves operating in the cross hairs of the new regulatory environment.

The documentation tracing the development of Reg FD is long and extensive. In December 1999, the Securities and Exchange Commission issued a proposal designed to provide the general public with the same access to information about public companies as Wall Street professionals. In short, Reg FD states that when a company, or a senior corporate official acting on behalf of the company discloses material, non-public information to certain securities market professionals, or to stockholders "who may well trade on the information," then the company must make the same disclosure to the public. This proposed rule to level the playing field for individual investors attracted widespread attention and drew nearly 6,000 comment letters.

Prior to the adoption of Reg FD, selective disclosure was lawful and widespread. The many supporters of the rule argued that the Securities and Exchange Commission should prohibit selective disclosure for two principal reasons. First, the practice undermined the integrity of our nation's securities markets, thus reducing investor confidence in the fairness of those markets. Second, it created incentives for analysts to refrain from making negative statements about the companies they followed in order to maintain their preferred access to information. These arguments and conflicting comments ultimately persuaded the Commission to approve a revised version of Reg FD in August 2000, and implementation began in late October 2000.

In the nearly seven months since Reg FD became effective, there has been a growing accumulation of surveys, anecdotes, and interpretations about its effects. Warren Buffet, the billionaire investor and head of Berkshire Hathaway, has, for example, praised the regulation. To date, the most obvious consequence of Reg FD appears to be that average investors have obtained better access to corporate communications. The most noticeable change is the open access for investors to company conference calls. Before the rule, one survey found that 80 percent of companies excluded individual investors from conference calls; now nearly all companies include individuals. Furthermore, a recent PricewaterhouseCoopers survey of 164 publicly held high-tech firms found not only that more companies are disclosing more information more frequently after the rule's implementation, but also that few firms have incurred significant compliance costs.

That said, concerns about the rule's effects have arisen in four broad categories. First, conflicting evidence has turned up about the quality and quantity of market information provided as a result of Reg FD. Second, questions continue to circulate about the actual access of individual investors to material market information. Third, some assert that the costs of complying with the regulation have exceeded the SEC's estimates. Finally, some have contended that the regulation's implementation has unnecessarily increased volatility in stock market prices. These issues merit our consideration and review today.

From my perspective, individual investors on Main Street should have access to the same information as the pros on Wall Street, and the preponderance of preliminary evidence indicates that the SEC's regulation's tangible and intangible benefits are increasingly outweighing its costs. It is, however, also too early to know for certain how the fair disclosure rule is working. With time and experience, I expect that the industry's concerns about Reg FD will likely fade as the marketplace becomes comfortable with the enforcement of the standard. In the meantime, we should work in Congress to closely monitor SEC's actions to implement its rule and appropriately refine its enforcement approach.

In closing, Mr. Chairman, I believe it important that we learn more about the views of the parties testifying before us today about Reg FD. I also commend you for putting together two panels that hopefully will allow us to engage in a fair, comprehensive, thoughtful, vigorous, and balanced debate. I therefore look forward to hearing from our witnesses about their impressions on this regulation and yield back the balance of my time.

Testimony of Congresswoman Sue Kelly House Committee on Financial Services Subcommittee on Capital Markets Hearing on Regulation Fair Disclosure

Thursday, May 17, 2001 – 10:00 a.m. – 2129 Rayburn

Chairman Baker, Ranking Member Kanjorski, I want to thank you both for agreeing to hold this hearing on the affects of Regulation Fair Disclosure. As Chairwoman of the Oversight and Investigations subcommittee I have a very keen interest in the proper operation of the markets which must include transparency for investors.

While I am a firm believer in allowing the market to operate freely, government has an important role in ensuring that the playing field is level with equal access to all and that all participants have equal access to information. Regulation Fair Disclosure has the laudable goal of doing just that and ensuring equal access to market information. However, I believe there may be unintended consequences to the implementation of this regulation that may in fact encourage less disclosure of information. If this is indeed the case, I believe corrective action is in order.

I want to thank our distinguished panel of witnesses for taking the time to join us here today and share their considerable knowledge on this issue. I look forward to discussing these issues with you all in detail.

Thank you again Mr. Chairman and I yield back the balance of my time.

Statement of Congressman John LaFalce, Ranking Member

Committee on Financial Services

Hearing on Fair Disclosure Regulation Before the Capital Markets Subcommittee

May 17, 2001

I would like to welcome our distinguished witnesses today to this important public discussion of the Fair Disclosure Regulation or, as it has come to be known, Regulation FD.

Regulation FD was adopted to confront a serious problem: companies making selective and important disclosures of material, non-public information to analysts, institutional investors, but not to the public at large. This practice disadvantaged the small retail investor and other market participants who did not have the access, or the privileged relationships, of analysts and powerful institutional investors. It undermined the fundamental premise that the market is both efficient and fair because of the broad dissemination of meaningful information to all investors at the same time.

The rule requires that when a senior official of a company discloses material non-public information to a shareholder or market professional, then the company must: (1) make all intentional disclosures public simultaneously, or (2) "promptly" for non-intentional disclosures. In my view, FD is an important and needed step to level the playing field for investors. The Regulation has gone a long way in ending the practice of selective disclosure to industry analysts and powerful institutional investors.

It is possible that FD over time may, in fact, encourage companies to communicate directly with their investors in a more fair and transparent way. In addition, although FD was not

precisely designed to do so, it may also help ensure that analysts remain a truly independent source of information for investors. The Regulation should encourage analysts who have sometimes inappropriately become cheerleaders for the investment banking industry to return to the work of real objective analysis of company fundamentals, and not rely on the privileged access that permeated the pre-FD environment.

At the same time, I am concerned about claims that FD may contribute to market volatility, and I am interested in hearing the panelists' views on this point. The argument, as I understand it, is that the market is often surprised by results in the absence of analysts' guidance ahead of official information by companies. One could also argue that the price effect of an announcement may simply be compressed into a shorter time period, rather than the several days typical under the old regime of analyst guidance.

I am also eager to hear from not only the SEC, but our other guests as well, about the possible chilling effects FD may have produced. Perhaps the SEC should consider some specific guidance on what is "material" to assist companies in their disclosure decisions. It will also be important for companies to understand the SEC's enforcement posture as they evaluate their own risk profile.

As we confront claims that the quality of disclosure has suffered, we also must consider that this disclosure framework is in its infancy and there is much data yet to be gathered. Companies, analysts and investors are clearly adjusting to the important changes FD has brought. In many ways companies are learning how to communicate in an unfiltered way with their investors. This will take time. Over the coming months we will look to the SEC, the securities industry and the investors themselves to guide us on the effects of FD.

I believe this hearing today is an important first step in this direction. I would like to thank Congressman Baker and Congressman Kanjorski for bringing this important and distinguished panel together as we attempt to do our part in protecting investors and enhancing the efficient operation of the United States capital markets. I look forward to your testimony. Thank you.

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
May 17, 2001

"Fair Disclosure or Flawed Disclosure: Is Reg FD Helping or Hurting Investors?"

Good morning and welcome to Acting Chairman Unger, Commissioner Hunt, and all of our distinguished witnesses today.

I want to thank Chairman Baker for holding this important hearing on Regulation FD. It will give members of this subcommittee the opportunity to hear first hand from not only the Commission but also market participants regarding their early experiences with Regulation FD.

The "FD" in Regulation FD stands for "fair disclosure." That is a goal nobody could oppose. Indeed, fair, and better disclosure for investors is more important than ever before, as individual investors transform this country from a nation of savers to a nation of investors. Over half of the citizens of this country now own equities, either directly or through mutual funds, retirement plans, and other investment vehicles. Information about the companies on which these investors are depending for their retirement savings, their children's college tuition, and other investment goals is the lifeblood of our marketplace, the most fundamental tool investors need. Promoting the fair and efficient flow of this information is the worthy goal behind Reg FD.

Indeed, improving the quality of and access to market information for investors is a touchstone for this Committee. We have already begun work on this important subject in the context of improving regulations governing market data, and will continue that work in the coming months as we examine other ways in which we can increase the quality and availability of market information for investors.

(more)

Make no mistake, I – and, I suspect, every member of this Committee – am in favor of fair disclosure. I am concerned, however, that the important goal that Regulation FD was designed to achieve may be more elusive than proponents of the rule might have thought. Many market participants, some of who are here today to share their views, have reported that the rule has led not to fair disclosure, but to flawed disclosure. They observe that the rule may, in fact, be limiting the quality of information that investors receive about the marketplace. If that is the case, then the rule is not achieving its goal – and should be fixed.

Others disagree, and argue that the rule has improved the quantity and fairness of information provided to the marketplace. These proponents, also represented on our panels here today, believe the rule has leveled the playing field for individual investors.

We are here today to find out what has actually transpired in the wake of Reg FD. I am most interested in learning our witnesses' views on whether the rule has led to investors getting more information about the markets or less, and what impact the rule has had on the quality of that information. I am also interested in hearing their views on whether Reg FD has contributed to the market's volatility. Increasing market volatility, especially in the down market we've seen in the past year, is not something that most investors welcome. I would like to hear our witnesses' views on whether we, or the Commission, should consider any changes to the rule to ensure that the rule does, in fact, achieve the goal of helping investors by improving the market information they receive.

I thank each of our witnesses for coming today to discuss this issue, and I look forward to your testimony.

WRITTEN STATEMENT OF THE U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING REGULATION FD ("FAIR DISCLOSURE")

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

MAY 17, 2001

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

WRITTEN STATEMENT OF
THE U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING REGULATION FD ("FAIR DISCLOSURE")

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COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

MAY 17, 2001

Chairman Baker, Congressman Kanjorski and Members of the Committee:

The Securities and Exchange Commission ("SEC" or "Commission") is pleased to submit this statement concerning Regulation FD, which is sometimes referred to as Regulation Fair Disclosure. The Commission adopted Regulation FD last year to address the problem of "selective disclosure" of material information by issuers of securities. Selective disclosure and Regulation FD have been matters of great interest and importance to investors in our securities markets, securities issuers, and market professionals. We appreciate the Committee's interest in this area.

This statement provides a brief overview of the background to Regulation FD and the rulemaking process undertaken by the Commission, a summary of the key provisions of the Regulation, and a discussion of the Commission's experience in the first months under the new Regulation. The Acting Chairman and each of the Commissioners will also be making a separate statement to the Committee regarding Regulation FD.

BACKGROUND OF REGULATION FD

1. "Selective Disclosure" and Insider Trading Law

Regulation FD grew out of the Commission's concern about the practice of "selective disclosure." The term "selective disclosure" refers to a practice by which issuers of securities selectively provide material, nonpublic information to certain persons – often, securities analysts or institutional investors – before disclosing this same information to the public.

Selective disclosure raises several concerns. The primary issue is the basic unfairness of providing a select few with a significant informational advantage over the rest of the market. This unfairness damages investor confidence in the integrity of our capital markets. To the extent some investors decide not to participate in our markets as a result, the markets lose a measure of liquidity and efficiency, and the costs of raising equity capital are increased. Further, if selective disclosure is permitted, corporate management can treat material information as a commodity to be used to gain or maintain favor with particular analysts or investors. This practice could undermine analyst objectivity, in that analysts will feel pressured to report favorably about a company or slant their analysis to maintain access to selectively disclosed information. Thus, selective disclosure may tend to reduce serious, independent analysis.

Prior to Regulation FD, the legal question presented by selective disclosure was whether this practice violated insider trading law and was thus subject to civil and criminal penalties as a type of securities fraud. Under judicial interpretations regarding insider trading law, the answer has not always been clear. Early insider trading case law appeared to require that traders have equal access to corporate information, and indicated

that selective disclosure of material information to securities analysts could lead to insider trading liability.[1] This changed, however, with the Supreme Court's decisions in *Chiarella v. United States*[2] and *Dirks v. SEC*.[3] In the *Dirks* case, in particular, which concerned the disclosure of material nonpublic information by a company insider to an analyst, the Court's decision indicated that insider trading liability would arise only when the insider received a "personal benefit" from giving the information to the analyst. After *Dirks*, there have been very few insider trading cases based on disclosures of material nonpublic information to, or trading by, securities analysts.[4]

Against this backdrop of legal uncertainty, the Commission began to see increasing numbers of public reports that issuers were disclosing important nonpublic information, such as advance warnings of earnings results, to selected securities analysts or institutional investors before public disclosure.[5] Even after Commissioners began to focus public attention on this practice through speeches,[6] reports of additional selective disclosures continued. The issue for the Commission then became what, if any,

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1 *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968)(en banc), *cert. denied*, 394 U.S. 976 (1969); *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8 (2d Cir. 1977).

2 445 U.S. 646 (1980).

3 463 U.S. 646 (1983).

4 The rare case involving a disclosure to securities analysts is *SEC v. Phillip J. Stevens*, Litigation Release No. 12813 (Mar. 19, 1991), a settled matter where the Commission alleged that a corporate official's "personal benefit" from the disclosure arose from a desire to protect and enhance his reputation.

5 A number of reported examples of this practice are cited in the Commission's rulemaking releases. *See* Proposing Release, 64 FR 72590, 72591 & fn. 11 (Dec. 28, 1999); Adopting Release, 65 FR 51716, 51717 & fn. 11 (Aug. 24, 2000).

6 *See, e.g.*, Remarks of Chairman Arthur Levitt to the "SEC Speaks" Conference, "A Question of Integrity: Promoting Investor Confidence By Fighting Insider Trading" (Feb. 27, 1998); Remarks of Commissioner Isaac C. Hunt, Jr., "Navigating the Sea of Communications" (Feb. 26, 1999); Remarks of Commissioner Laura S. Unger, "Corporate Communications Without Violations: How Much Should Issuers Tell Their Analysts and When" (Apr. 23, 1999). Copies of these speeches are available on the SEC's website at www.sec.gov.

regulatory response was appropriate. One option would have been to pursue a series of "test cases" charging fraudulent insider trading in some of these matters, with the goal of clarifying existing judicial interpretations in this area. Ultimately, however, rather than engage in what some might call "regulation by enforcement," the Commission determined that the better approach was to engage in rulemaking proceedings, with full opportunity for public notice and comment, in order to craft a more targeted regulatory response to selective disclosure.

2. The Commission's Public Rulemaking for Regulation FD

The Commission proposed new Regulation FD at an open meeting held on December 15, 1999.[7] This proposal did not treat selective disclosure as a form of insider trading, but instead proposed a new, non-fraud based, issuer disclosure rule aimed at the practice. Proposed Regulation FD was highly publicized and generated great public interest. In addition, Commission staff conducted outreach efforts to ensure that affected members of the regulated community were aware of the proposal and to encourage participation in the public rulemaking process.[8] The Commission received more than 6,000 comment letters on the proposal, most of which were posted on the Commission's website as they were received, where they remain available for public review.

The vast majority of commenters were individual investors who urged the Commission to adopt Regulation FD. Individual investors expressed strong support for

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[7] The Proposing Release was published in the Federal Register on December 28, 1999. Selective Disclosure and Insider Trading, 64 FR 72590 (Dec. 28, 1999). (In addition to Regulation FD, the proposal also contained proposed rules 10b5-1 and 10b5-2, which dealt with discrete issues under insider trading law.) The Commission originally provided for a 90-day public comment period, which was later extended for an additional 30 days. 65 FR 16160 (March 27, 2000).

[8] For example, shortly after the proposal the Commission's former General Counsel participated in a conference call sponsored by the National Investor Relations Institute to discuss and answer questions about proposed Regulation FD. During the comment period, the Commission staff held numerous meetings with interested parties, including industry and bar association representatives.

the regulation. Many noted that selective disclosure is indistinguishable from insider trading in its effect on the market and their perception of the market's fairness. Others reported that today's self-directed, online investors conduct their own research and analysis and do not expect to rely exclusively on analysts' research and recommendations. With advances in information technology, these investors noted, information can be communicated to investors directly and in real time, without the need for intermediaries.

In addition to the thousands of investor comments, the Commission received many comments from a range of other interested parties: securities industry participants, issuers, attorneys, media representatives, and professional and trade associations. Almost all of these commenters agreed that selective disclosure of material nonpublic information was inappropriate and supported the Commission's goals of promoting broader and fairer issuer disclosure. While some of these commenters believed the proposed regulation was generally appropriate as a means of addressing selective disclosure, many others expressed concerns about the approach and suggested alternate methods of achieving the goals or recommended various changes to the proposed regulation. One frequently expressed concern was that rather than resulting in broader dissemination of information, Regulation FD might "chill" issuer disclosure practices. In order to avoid this effect, some commenters stated that the Commission should not adopt an enforceable rule against selective disclosure, but instead should encourage issuers to voluntarily engage in "best practices" with regard to disclosure. Other commenters recommended various ways that the Commission could narrow Regulation FD's scope to address this and other concerns.

In response to the comments received on the proposal, the Commission made several significant changes to the final rules, to narrow its scope and further guard against any chilling effect.

- First, the Commission narrowed the scope of the regulation to apply to a relatively limited category of issuer communications. The effect of these changes is that Regulation FD does not apply to ordinary-course business communications or disclosures to the media.
- Second, the Commission added a provision to Regulation FD to make it absolutely clear that private plaintiffs cannot rely on an issuer's Regulation FD violation as a basis for a private action alleging fraud.
- Third, the Commission made changes to the regulation to give issuers greater assurance that they would not be second-guessed by the SEC in enforcement actions for mistaken judgments about materiality in close cases.
- Fourth, the Commission made several changes to address concerns about the interplay between Regulation FD and the Securities Act of 1933 ("Securities Act") -- most notably, expressly excluding from the scope of Regulation FD communications made in connection with most securities offerings registered under the Securities Act. These changes significantly reduced the reach of the regulation.

With these changes, the Commission adopted Regulation FD at an open meeting held on August 10, 2000.[9]

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[9] Former Chairman Levitt, Commissioner Hunt, and Commissioner Carey voted to adopt the regulation; then-Commissioner, now Acting Chairman, Unger dissented. Acting Chairman Unger's dissent

SUMMARY OF REGULATION FD

The final rule adopted by the Commission is fairly straightforward. Under Regulation FD, whenever:

(1) an issuer, or person acting on its behalf;

(2) discloses material nonpublic information;

(3) to certain enumerated persons (in general, securities market professionals or holders of the issuer's securities whom one has reason to believe will trade on the basis of the information);

(4) the issuer must make public disclosure of that same information:

a. simultaneously (for intentional disclosures), or

b. promptly (for non-intentional disclosures).

As a whole, the regulation requires that when an issuer makes an intentional disclosure of material nonpublic information to a person covered by the regulation, it must do so in a way that provides general public disclosure, rather than through a selective disclosure. If an issuer makes a non-intentional selective disclosure, the issuer must publicly disclose the information promptly after it knows (or is reckless in not knowing) that the information selectively disclosed was both material and nonpublic.

A more detailed explanation of some of the regulation's key requirements is provided below.

1. Whose disclosures are covered?

Regulation FD applies to most issuers of publicly-traded securities. Specifically, it covers all issuers with securities registered under Section 12 of the Securities Exchange

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was based on her belief that Regulation FD was an overly broad solution to the acknowledged problem of selective disclosure.

Act ("Exchange Act") and all issuers required to file reports under Section 15(d) of the Exchange Act, including closed-end investment companies, but not including other investment companies, foreign governments, or foreign private issuers.[10]

The regulation applies to disclosures made by a "person acting on behalf of an issuer." That term is defined as (1) any senior official of the issuer[11] or (2) any other officer, employee, or agent of an issuer who regularly communicates with certain types of securities market professionals or with the issuer's security holders.[12] Thus, the regulation covers senior management, investor relations professionals, and others who regularly interact with securities market professionals or security holders. An issuer can designate particular officials as its authorized spokespersons for purposes of the regulation.

2. Disclosures to whom are covered?

Regulation FD's general rule against selective disclosure applies only to disclosures made to four categories of persons.[13] The first three are securities market professionals – (1) broker-dealers and their associated persons, (2) investment advisers, certain institutional investment managers, and their associated persons, and (3) investment companies, hedge funds, and affiliated persons. These 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. The fourth category of persons covered is any holder of the issuer's

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[10] 17 CFR 243.101(b).

[11] "Senior official" is defined as any director, executive officer, investor relations or public relations officer, or other person with similar functions. 17 CFR 243.101(f).

[12] 17 CFR 243.101(c).

[13] 17 CFR 243.100(b)(1).

securities, under circumstances in which it is reasonably foreseeable that such person would trade securities on the basis of the information. Thus, Regulation FD is designed to cover the types of persons most likely to receive and trade on improper selective disclosure, but not persons engaged in ordinary-course business communications with the issuer. Similarly, Regulation FD does not cover disclosures to the media or communications to government agencies.

There are four specific exclusions from coverage provided in the regulation: (1) communications to a person who owes the issuer a duty of trust or confidence, such as an attorney, investment banker, or accountant, (2) communications to any person who expressly agrees to maintain the information in confidence, (3) disclosures to credit ratings agencies, provided the information is disclosed solely for the purpose of developing a credit rating and the entity's ratings are publicly available, and (4) communications made in connection with most offerings of securities registered under the Securities Act.[14]

3. "Material nonpublic information"

Regulation FD applies to disclosures of "material nonpublic information" about the issuer or its securities.[15] The regulation relies on existing definitions of "material" and "nonpublic" established in the case law. Information is "material" if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision.[16] To be material there must be a substantial likelihood

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[14] 17 CFR 243.100(b)(2).

[15] 17 CFR 243.100(a).

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

that a fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[17] Information is nonpublic if it has not been disseminated in a manner making it available to investors generally.[18]

In response to a number of comments suggesting more interpretive guidance about types of information or events that are more likely to be considered material, the Commission included in the Adopting Release a list of the following items as some types of information or events that should be reviewed carefully to determine whether they are material: (1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers; (4) changes in control or in management; (5) change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report; (6) events regarding the issuer's securities; and (7) bankruptcies or receiverships.[19]

One area of concern was the practice of issuers providing "guidance" to securities analysts regarding earnings forecasts. The Adopting Release stated that an issuer official who engages in a private discussion with an analyst seeking guidance about earnings estimates takes on a high degree of risk under Regulation FD.

At the same time, although Regulation FD prohibits selective disclosure of *material* nonpublic information, an issuer may still disclose *non-material* information to an analyst even if that information helps the analyst complete a "mosaic" of information

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17 *Id.*

18 *See, e.g., SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 854 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *In re Investors Management Co.*, 44 S.E.C. 633, 643 (1971).

19 65 FR at 51721.

that, taken as a whole, is material. The focus of Regulation FD is material nonpublic information, not information that an analyst, through some combination of persistence, knowledge and insight, regards as material, even though its significance would not be apparent to the reasonable investor.

Further, the Commission made clear that the "simultaneous" disclosure requirement in the regulation applies only when issuers know or are reckless in not knowing that the information disclosed was material. This provides additional assurance that issuers need not fear being second-guessed by the Commission in enforcement actions for mistaken judgments about materiality in close cases.

4. Timing of required public disclosure under Regulation FD

Under Regulation FD, the timing of required public disclosure differs depending on whether the issuer has made an "intentional" or "non-intentional" selective disclosure. For an intentional selective disclosure, the issuer is required to publicly disclose the same information simultaneously.[20] Regulation FD states that a selective disclosure is "intentional" when the issuer or person acting on behalf of the issuer either knows, or is reckless in not knowing, at the time of disclosure, that the information he or she is communicating is both material and nonpublic.[21]

When an issuer makes a selective disclosure that is "non-intentional," it is required to make public disclosure promptly.[22] "Promptly" means as soon as reasonably practicable but not after the later of 24 hours or the start of the next day's trading on the

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[20] 17 CFR 243.100(a)(1).

[21] 17 CFR 243.101(a).

[22] 17 CFR 243.100(a)(2).

New York Stock Exchange, after a senior official learns of the disclosure and knows (or is reckless in not knowing) that the information disclosed was both material and nonpublic.[23]

5. How to make the required public disclosure

Regulation FD gives issuers flexibility in determining how to make the required public disclosure. Issuers can make "public disclosure" of material information by including it in a Form 8-K filed or furnished with the Commission.[24] Alternatively, issuers can make public disclosure "through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public."[25]

This alternative standard does not require use of any particular method or establish a "one size fits all" disclosure standard for issuers. Instead, issuers are able to choose the method or combination of methods best suited to their own circumstances as long as the method (or combination of methods) is reasonably designed to effect broad public disclosure. The Adopting Release states that generally acceptable methods of public disclosure include press releases distributed through a widely circulated news or wire service, or announcements made through press conferences or open conference calls that the public may attend or listen to either in person, by telephone, or by other electronic transmission (including the Internet). An issuer must give the public adequate notice of the conference or call and the means for accessing it.

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[23] 17 CFR 243.101(d).

[24] 17 CFR 243.101(e)(1).

[25] 17 CFR 243.101(e)(2).

The Adopting Release sets forth the following "best practices" model, which employs a combination of disclosure methods for making a planned disclosure of material information, such as a scheduled quarterly earnings release: (1) issue a press release containing the information; (2) provide adequate notice, via a press release and/or a website posting, of a conference call to discuss the announced results, providing the date and time of the call and instructions for accessing it; (3) hold the conference call in an open manner, allowing investors to listen on the phone or through a webcast.

6. Liability for violations of Regulation FD

The Commission recognized that the prospect of private liability under Regulation FD could contribute to a "chilling effect" on issuer communications. Accordingly, the regulation expressly provides that a failure to make a disclosure required solely by Regulation FD will not violate the general antifraud rule, Rule 10b-5.[26] Thus, private plaintiffs cannot rely on a Regulation FD violation as a basis for a private securities fraud lawsuit. The regulation is enforceable only by the Commission.

REGULATION FD: EXPERIENCES OF THE FIRST SEVERAL MONTHS

As noted, the Commission adopted Regulation FD on August 10, 2000. The regulation became effective on October 23, 2001, and has been in effect for just over six months.

In the short time since the regulation was adopted, the Commission's staff has provided oral and written interpretive guidance regarding Regulation FD. The Division of Corporation Finance's Office of Chief Counsel has answered numerous telephone requests for interpretive advice on the regulation. Even before the rule became effective,

[26] 17 CFR 243.102.

the Division published written "Qs&As" responding to certain questions raised by issuers or their counsel, and it has since supplemented this staff interpretive guidance. Moreover, Commission senior staff have given speeches and participated in numerous legal and industry forums to discuss Regulation FD. These continuing efforts to meet requests for guidance have been designed to smooth the transition in the behavior and expectations of issuers, analysts, institutional investors and the investing public.

The Commission has not brought any enforcement cases thus far based on violations of Regulation FD. In light of concerns expressed by some about the threat of possible unwarranted enforcement actions, the Commission's Director of Enforcement has publicly stated that Regulation FD was not designed as a "trap for the unwary" and that enforcement cases will not be based on second-guessing reasonable judgments made in good faith by issuers, including judgments about materiality.[27] These remarks, and similar ones by other Commission officials, have indicated that Commission enforcement of the regulation will be focused on clear violations.

Because of the significance of Regulation FD, the Commission has been committed to carefully evaluating its operation and effects. At the open meeting during which the regulation was adopted, the Commission asked the SEC's Office of Economic Analysis to conduct a study of Regulation FD's effect after sufficient time had passed to gather the appropriate data. That Office has begun to examine several questions regarding the possible effects of Regulation FD, although in consultation with leading academics it has concluded that significantly more data than is currently available will be necessary to complete its task. In addition, it has been noted by various commentators

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[27] Richard H. Walker, "Regulation FD – An Enforcement Perspective," Remarks to the Compliance and Legal Division of the Securities Industry Association (Nov. 1, 2000).

that the precipitous change in current market conditions and other structural changes in markets will require a longer window of experience with Regulation FD to effectively measure its impact.

The Commission and staff have also closely monitored the results of preliminary surveys and reports generated by others concerning the operation and effects of Regulation FD. These surveys, however, have reflected perceptions of behaviors only over the initial transition period under the regulation, during which issuers and market participants have been adjusting to its requirements.

Since Regulation FD became effective, the Commission has reaffirmed its commitment to monitor its effects. On April 24, Acting Chairman Unger moderated a roundtable discussion in New York City among industry participants, issuers, media, investor groups, academics, and attorneys to discuss experiences to date with Regulation FD. The discussion was open to the public and simultaneously webcast for the benefit of those who were interested but unable to attend in person.[28]

Roundtable panelists commented on several important issues, including the flow of information from issuers, the role of analysts in the marketplace, and market volatility. Given the diverse backgrounds and experiences of the participants, the discussion was robust and the participants often disagreed. Representatives of issuers differed on the extent to which Regulation FD has altered their disclosure practices. Participants representing disseminators of information, including wire services, generally agreed that issuers are making more public disclosure since Regulation FD took effect. Securities analysts generally felt that Regulation FD had negatively affected their ability to obtain quality information from issuers. One relatively common point of agreement, however,

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[28] The webcast is archived and remains accessible on the Commission's website at www.sec.gov.

was that it was still very early to assess the impact of Regulation FD, given the limited period of time in which the regulation had been in effect and the variety of other unusual conditions that have affected the markets during this period. There was also a sense among many roundtable participants that more guidance or "best practices" regarding compliance with the regulation might be helpful for the future.

Acting Chairman Unger is preparing a report that will provide more detailed observations about the roundtable discussion.

CONCLUSION

The Commission adopted Regulation FD after rulemaking proceedings in which it heard comments from all points of view. Both critics and supporters of the regulation have continued to debate its merits and effects from the moment of its adoption to the present. While the Commission has followed this continuing debate with interest, it is still very early to measure in any objective manner the effects of Regulation FD. Given the importance of Regulation FD, the Commission remains committed to a careful examination of the effects of the regulation as we gain greater experience under it, and to consideration of the need for additional interpretive guidance as appropriate.

"The Empty Playing Field"

James K. Glassman
Resident Fellow, American Enterprise Institute

and
Host, www.TechCentralStation.com

Testimony Before Hearing on "Fair Disclosure or Flawed Disclosure: Is Reg FD helping or hurting investors?"

Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
The Hon. Richard H. Baker, Chairman

May 17, 2001

American Enterprise Institute
1150 17th Street, N.W.
Washington, DC 20036
202/862-7198

On Aug. 10, 2000, the Securities and Exchange Commission approved Regulation FD, for "Fair Disclosure," which required firms to release "material" information about their business to everyone if they release it to anyone. The regulation became effective two and a half months later. While the purpose of Reg FD was to help small investors, it has actually hurt them. Since the regulation was enacted, the volatility of markets has increased – making them scarier places for the public and increasing the cost of capital for corporations. The regulation appears to have led to less disclosure of information by companies, and it has certainly led to a lower quality of information emanating both from those companies and from the analysts who cover them. Again, the result has been to hurt the investing public, the prospective beneficiary of the regulation.

As the SEC prepared to vote last summer on the new regulation, the general counsel of the Securities Industry Association, Stuart Kaswell quipped, "The playing field will be more level" if Reg FD is approved, "but it will be empty."

While I do not always agree with the SIA, Mr. Kaswell's comment turned out to be prescient -- only a slight exaggeration. Reg FD is not just unnecessary. It has proven counterproductive.

Were the adverse consequences – the increased volatility and the decreased information and analysis -- unintended? That's hard to believe. Warnings abounded before the Reg FD was approved and even advocates admitted that higher volatility was a likely result. For example, in an op-ed piece in The New York Times shortly before approval of the regulation, Daniel Gross, author of the book *Bull Run* and a supporter of the rule, admitted the obvious: Reg FD "will surely bring greater volatility."

Then, did the SEC believe that adverse consequences were simply the price that had to be paid to achieve more important objectives: "fairness" through the elimination of special advantages enjoyed by analysts and professional investors and "objectivity" through the elimination of a system that could reward analysts with access if they gave favorable reports?

That seems likely. My own view, however, is that high volatility and degraded information quality have been far too high a price for small investors to pay for a particular vision of fairness.

I speak as someone who has devoted much of his professional life to educating small investors and advocating policies to help them. For nearly 20 years, I have been writing about finance and economics while, in recent years, also serving as a resident fellow at the American Enterprise Institute for Public Policy Research in Washington, D.C., and hosting a website that focuses on the nexus among technology, public policy and finance. From 1993 through 1999, I wrote an internationally syndicated twice-weekly investing column for the Washington Post. I then became the first investment columnist in the history of Reader's Digest, the largest-circulation magazine in the world. I am co-author of a book, *Dow 36,000*, which examines stock valuation, and I currently write regular investing columns for the International Herald Tribune; the New York Daily News; www.foliofn.com; and my own website, www.TechCentralStation.com. I am currently writing a primer for small investors that will be published by Crown Books early next year. In all these efforts, my aim has been to inform small investors, many of whom have been thrust into the market with little preparation. My strong belief is that, for most

Americans, the stock market is the only route to the kind of wealth necessary for a comfortable retirement, so understanding the market and investing wisely is not a luxury but a necessity.

I have generally applauded the work of the SEC during the tenure of chairman Arthur Levitt Jr. Mr. Levitt was my business partner from 1998 to 1993, when we were owners together of Roll Call, the Congressional newspaper that I edited. The concern of Mr. Levitt and his fellow commissioners for small investors was important during the 1990s, a period of turbulent markets and the entry of tens of millions of new investors. But, at times, the commission's appropriate concern has led to inappropriate policy – mainly because of a lack of faith in the free markets and the competitive process. Reg FD is a prime example of a top-down regulatory policy that disrupts an often-messy process which, ironically, produces better results for small investors.

Is it fair that corporate executives share information with some analysts and not others – or with some analysts and not the public at large? Fairness is a word whose meaning can only be personal, not precise. Is it fair that elected officials, including many members of Congress here today and certainly even commissioners of the SEC, share information with selected journalists and not others – or with some journalists and not the public at large? That would seem to be even *less* fair than selective sharing by corporate executives since public officials, by definition, serve the public. Yet selective sharing by politicians happens every day and undoubtedly works not only to promote good policy but also to promote the financial well-being of journalists and their publications. (The

journalists' stature and perhaps salary are enhanced, and the publication sells more copies.)

Certainly, selective sharing of information by politicians is a way to put more information into circulation. Without that sharing, the information might not come out at all, or might not be understood.

The vague concept of fairness must be balanced against a concept more substantial – that of encouraging the dissemination of as much information and analysis as possible (and of as high a quality as possible) so that investors can make decisions related to securities ownership. If a fairness regime inhibits the flow of information and analysis, then it may be counterproductive. That is the case with Reg FD.

Just a simple example. Companies now regularly broadcast conference calls not only to analysts but also to the general public, which tunes in through the Internet. This kind of general sharing of information is fine. But, in the past, when analysts had questions about the conference call, they would themselves call up and ask company officials after the call was over. Those officials would often provide needed guidance. With Reg FD, they no longer do so. In the end, it is the public that is hurt by this reduced information.

What is the best way to encourage the dissemination of information? Not government rules, but open competition. Competition, driven by consumer choice, is the key to abundance and variety in the marketplace both of goods and services and of ideas. Analysts compete. They work to get information about corporations because that information – plus subsequent judgments they draw from it – gives them an edge over

other analysts. As my colleague Kevin Hassett, an economist at the American Enterprise Institute, has written: "Analysts do this hard work because they (or their firms' clients) will profit if they are a little bit smarter than the next guy." It is the potentially asymmetrical nature of the distribution of information that triggers the competition from which, in fact, all investors benefit – whether they are clients of the analyst with the initial edge or not.

If information, by law, is relayed to all analysts – and, in fact, to all citizens – at the same time and in the same way, then the incentive for hard work by analysts declines sharply. Less information comes out. And small investors suffer.

While the Internet offers the technology to make vast amounts of information about companies available to investors, the role of analysts remains critical. Raw numbers don't help most investors, who have a hard time telling an income statement from a balance sheet. More than ever, they need analysts to analyze, to tell them what the numbers mean – and to ask corporate managers to find out. While analysts sometimes make mistakes, their efficacy has been established in academic research, including a key paper by Keane and Runkle (American Economic Review, Sept. 1990, pp. 714-35) titled, "Testing the Rationality of Price Forecasts."

In addition, according to several surveys, Reg FD has led skittish companies simply to disclose less information. For example, at an Institutional Investor roundtable for the heads of major mutual funds, an on-site survey found that 88 percent agreed or strongly agreed that Reg FD has been a "chill" on the flow of information from

companies. And 82 percent said companies today provide less information than they did before the regulation.

On the very day last year that Reg FD officially went into effect, *The Wall Street Journal* ran an article about Matthew Berler, a Morgan Stanley Dean Witter analyst, who tried to ask a Georgia-Pacific executive for the usual guidance with Berler's spreadsheets, which cover 887 financial factors regarding the company. This time, though, he got no help from Georgia-Pacific, which was worried about violating Reg FD. As a result, says Berler, "there's a greater chance of error." (A study by the Securities Industry Association has since shown that 93 percent of analysts have noted a decline in issuer reviews of their reports.) Also on the day FD was launched, *The Washington Pos*t reported that the chief financial officer of TeleCommunication Systems, Inc., on advice of his lawyer, would not answer the questions of an influential Wall Street tech analyst.

But the object of the rule is not to help analysts. It is to help investors.

What is Reg FD giving investors? Less information, not more. As a result, the market is displaying more volatility, not less – since firms, even though they know what is happening in their own businesses, can't tell anyone unless they everyone. Frankly, we have enough volatility. Another word for "risk," volatility is the bane of every investor's existence. Higher volatility ultimately means lower stock prices since it raises the cost of capital and scares investors from the market.

Mr. Gross, in his New York Times article, argued that, despite higher volatility, the rule is a good one since "analysts seeking an edge will actually have to do some reporting and make gutsy calls." We can't argue with that. Many analysts are, indeed,

lazy – or, worse, they are merely shills for the companies they cover or patsies for their own firms, which often sell their investment banking services, at a nice profit, to the same companies their analysts praise.

But Reg FD, first of all, exacerbates the laziness problem since it discourages analysts from competing for fresh information, and it does nothing to help solve the coziness problem. Instead, it creates a completely new problem – an information bottleneck that squeezes the life out of the battle for information. In the past, an analyst may have gained a slight edge if a company leaked her some information, but that information quickly got circulated in this Internet age, and, within a very short time, it was available to all investors.

Instead, today, with information limited by Reg FD, investors have often been shocked, for example, by quarterly earnings results about which they may have learned, in a more gradual, less abrupt way, in preceding months. These shocks have almost certainly led to increased volatility, and high volatility leads small investors, especially, to make poor decisions about the stocks they hold and may acquire.

Also, press releases and earnings announcements present information in a less contextual manner in a post-FD world. As Frank Fernandez, chief economist for the Securities Industry Association, wrote in an article in SIA's Research Reports on April 30: "Additional content and analysis that used to accompany the release in the pre-FD environment…often functioned as a filtering mechanism and included the provision of financial advice to investors on how to respond to the arrival of this information. The release [now] produces an immediate price impact, which is amplified by the greater

uncertainty generated by the absence of context and additional content and the provision of analysis and advice."

Perhaps the quantity of information reaching the public has increased under Reg FD. Even so, the quality has declined. While I am a strong advocate for small investors, I agree with Louis M. Thompson Jr., president of the National Investor Relations Institute, who wrote in the Investor Relations Quarterly:

"Although the Internet is having a significant impact on disintermediation of the securities markets, analysts and professional investors still have an important role in the investment process. It takes a huge leap of faith to believe that most individual investors can take all the raw information to which they now have access and make sound investment decisions, particularly in a down market. Moreover, more than half of America's families invest, directly or indirectly, in mutual funds and rely on their portfolio managers to have access to quality information. Under Regulation FD, that is no longer the case."

Very simply, a more abundant flow of information dampens volatility. That was one of the great hopes for the Internet, and it was on its way to fruition before Reg FD.

Do we know for certain that Reg FD has increased volatility? Surveys of investment professionals indicate that it has, but, clearly, it is impossible, at this early stage, to separate the contribution to volatility made by the Reg FD and the contribution of other factors. Still, it certainly stands to reason.

What should be done about Reg FD? Don't fix it, as many issuers and securities industry officials have argued. Abolish it. Regulation FD is simply the latest

manifestation of an approach to regulation that is harmful to consumers because it denies them the benefit of free-market competition. Just as companies compete for the favor of customers, they will – given the chance – compete for the favor of investment analysts, their clients and investors at large. How? In part by trying to gain an edge on competitors by offering what analysts and investors want most – information. A company that can be relied upon for timely, abundant and thorough business data, placed in truthful context, is a company that will attract more capital – all else being equal. Investors don't like businesses to keep them in the dark.

What is the best way for such information to bloom? Free competition – not government rules. Regulations set both and floor and a ceiling on disclosure. They give businesses an excuse for not telling more. But Reg FD is even worse than typical disclosure regulations. Reg FD actually encourages businesses to tell less.

Imagine a securities regulator that simply policed fraud and insider trading. In the absence of regulations, would corporations still report earnings quarterly? Of course. (See an examination of the case of Germany in Cummins, Harris and Hassett in *The Effects of Taxation on Multinational Corporations*, p. 187, National Bureau of Economic Research, 1995.)

Some firms might do so even more frequently. Any firm that tried to hide its performance would lose investors; its stock price would drop, raising capital in the public markets would become more difficult.

What Reg FD reveals is a misguided, often destructive regulatory mentality – the hubristic notion that regulators stand between investors and chaos. That is simply untrue. Orderly markets in goods and services flourish without the heavy hand of regulation about disclosure (imagine if a car company could not talk with researchers from Consumer Reports without issuing a press release). Markets in financial information – given half a chance – will do the same.

Testimony of H. Perry Boyle, Jr. CFA

Deputy Director of Research
Thomas-Weisel Partners LLC

Concerning Regulation FD

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

May 17, 2001

I appreciate the opportunity to convey my views on Regulation FD to the Committee in my capacity as a private individual engaged in the practice of securities analysis. My invitation to appear before the panel was fairly recent, so I have not been able to include as much supporting data as I would have liked, but I think you will get the flavor of my views.

My name is Perry Boyle. I am a founding partner of Thomas Weisel Partners and serve as the Deputy Director of Research. I have been an equity analyst since the middle of 1992, and I have covered a variety of sectors, including transportation stocks, business services stock and marketing services stocks. I currently supervise a department of 35 analysts covering primarily growth areas of the economy.

For those of you unfamiliar with Thomas Weisel Partners, we commenced operations on February 1, 1999. Our headquarters are in San Francisco, and we have offices in New York, Boston. Menlo Park and London. We have three major business lines: asset management, merger and acquisition advisory, and traditional broker dealer services focusing on equity and convertible securities. From a zero revenue base in 1998, we achieved revenues of just under $500mm in 2000.

To clarify my general position on Reg FD, and I believe you can view me as a typical analyst in this, I support the same ends as the Commission on selective disclosure. Good analysts favor a system that provides broad, non-discriminatory dissemination of quality information. I also note that, from a sell-side analyst position that Reg FD increases the value of "good analysts" in the marketplace, so it would be disingenuous of me to rail against the Regulation. However, from a public policy perspective, the Regulation does have costs that are probably not yet fully appreciated, and it is questionable whether the benefits of the Regulation merit those costs.

In the remainder of my testimony, I will address each of the questions posed by the Committee in its letter inviting me to testify.

Whether there was a need for Regulation Fair Disclosure (Reg. FD) prior to its promulgation.

With the advent of the Internet, a broadening of the investor base and the media's increased interest in the stock market, a greater flow of information to a broader range of people was occurring prior to Regulation FD.

I don't believe there was much of a need for the Regulation. Lawyers can debate about the extent to which the law reached selective dissemination prior to Regulation FD, but the simple fact is that, with a handful of exceptions, there was little evidence that selective disclosure was a problem for the markets. I do not recall reading in the popular press of a groundswell of public demand for a new fair disclosure regulation until the SEC raised the issue and a few media outlets whipped up e-mail writing campaigns. Indeed, I doubt that the vast majority of America's 90 million investors even know about the rule or have any practical use for it, given that almost all of them depend on professionals such as fund managers or stock brokers to manage their accounts.

To the degree that Reg FD has raised public confidence in the capital markets, it is laudatory. I have seen no study that supports that conclusion, but a reasonable person would likely presume that, at least on the margin, Reg FD would help raise public confidence in the market.

Reg FD does not change the fundamental role of an analyst nor does it introduce a new moral or ethical duty on selective dissemination. It merely creates more uncertainty about what the definitions surrounding selective

dissemination are and how companies and analysts will be prosecuted for sharing information. It has injected uncertainty in the marketplace with an unreasonable definition of materiality and a lack of clarity on how the rule will be applied.

As a general rule, most of us involved in the capital markets believe that regulations that encourage efficient markets are good, and that regulations that impede market efficiency are not good. This is based on our education and experience that, over time, securities prices tend to reflect all the available information about that security.

The short term impact of Reg FD has been to reduce the flow of useful information from issuers to the investment community. Longer term, as we all learn how to live with it, that restrictive impact is likely to abate. In the information age with our plethora of media channels, it is hard to keep a lid on interesting news.

Prior to Reg FD, issuers took a wide variety of stances with the investment community vis a vis the amount of information they would share beyond the legally required disclosures. I have covered companies that released detailed monthly data regarding the volume and pricing of all their service lines; I have covered companies that had almost no communication with the investment community beyond the legally mandated disclosures. Prior to Reg FD there was no uniform standard of how much information an issuer shared with the investment community, and that has not changed post-Reg FD.

Indeed, now that the commission has dealt with "fair" disclosure, perhaps their next priority should be on "full" disclosure. In the normal course of filings under SEC regulations using Generally Accepted Accounting Principles, issuers exclude massive amounts of information that could be presumed material in making an informed investment decision about a company. The simple fact is that investors will always be making investment decisions based on a combination of imperfect information, varying degrees of analysis, experience, intuition and luck. That's what makes a market.

The rule is designed to increase public confidence in the "fairness" of the market. I have not seen any study used by the SEC that measured the public's lack of confidence in the market prior to the rule. I would note that the US securities markets are globally considered to be the fairest in the world; issuers from around the globe flock to our markets along with countless investors.

I am also unaware of any cost/benefit analysis that was done prior to the promulgation of the regulation.

It is instructive to consider who wins and who loses under Reg FD. Winners include:

- the SEC for a positive public relations move,
- lawyers engaged by issuers to ensure compliance with the regulation,
- investor relations and public relations personnel who have much logistical work to do,
- those members of the public who were concerned about fairness of information disclosure,
- the financial media who have more press releases to make sound bites out of,
- the business wires and webcast services companies,
- day traders who have more press releases to trade off of,
- market makers who benefit from increased volatility,
- good analysts who have always cultivated sources of information other than top management of issuers.

Losers include:

- issuers and their shareholders who have to bear the costs of compliance,
- investors who bear the costs of increased volatility,
- bad analysts who merely reported what they heard from management.

From a selfish perspective, Reg FD is good for me. It makes the job of an analyst more difficult by reducing the flow of quality information. Thus the difference in the quality of work between good and bad analysts should only widen. As I pride myself on being a "good" analyst, the regulation can only work to my benefit.

From a public policy perspective however, I question whether the cost to the public is worth the benefit, and I urge the Committee to conduct some research on this.

Why would issuers want to communicate information to the market via the analyst community rather than in a press release, conference call, 8-K or other public disclosure? I believe it is in large part a liability arbitrage created by the disclosure regulations. The SIA in its testimony today gives a good example of that in its discussion of why safe harbors should be expanded under the Regulation. Simply put, issuer management has a higher liability standard for information disclosure than does the analyst community. By conveying information via the analyst community, issuers can convey a myriad of details about their business and their industry that they would not necessarily want attached to their name. Is that necessarily an "unfair" system? To the degree that one firm's clients benefit from the information to the detriment of other investors, perhaps it is. But that is hardly how Wall Street works.

On an institutional investor level, one investment bank's clients are pretty much the same as everyone else's client base. Everyone is fishing in the same pond. So to think that one investment bank's clients would benefit from selective dissemination over another investment bank's clients is not really accurate, and any benefit would be transitory. Everyone's clients benefit from a "good call" from a particular analyst. As the vast majority of individual investors hold their investment in institutionally managed portfolios, they are indirect beneficiaries.

And it has always been my understanding that it was not permissible under the pre-Reg FD system for one analyst's clients to benefit from selective dissemination. For selective dissemination of an issuer to an analyst to work to the detriment of the general investment community presumes another layer of selective dissemination on the part of that analyst to a favored group of investors. That is not the case.

The issue of selective dissemination of research to our clients is a moot one. All our research calls are published on the standard dissemination systems such as First Call, Multex, etc., which pretty all our institutional clients have access to. Some of our clients use our the research, other don't. Some use the research for one purpose, other clients for another purpose. The myriad of investment approaches of our client base is what makes for the trading activity of the market.

I believe that the SEC may not have a very rich view of the role of the analyst. While I am certainly not asking for sympathy, there are only three things that an analyst knows with complete certainty every day:

1. I am wrong. If I was right all the time, I would not be doing sell-side research, I would be trading my own account
2. I will upset someone today. I am paid to have an opinion. Often, that opinion will be contrary to the opinion of others, including my clients, which can be upsetting to them. If I do not have an opinion I am not doing my job.
3. I will be lied to all day by just about everyone I talk to, especially the management teams of the companies I cover.

Our job is to anticipate market trends and figure out which companies will best capitalize on those trends to the benefit of their shareholders over long periods of time.
Analysts should not be day traders. We don't change our investment opinion on a stock based on every press release. That's called "whipsawing" your opinion. Indeed, if we are reacting to news in press releases, we are following stocks, not leading them.

I believe the Supreme Court got it right in the Dirks case:

> "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."

By reducing information flow to the analyst community through poor definitions of materiality and liability, with few safe harbors for the analyst community, the value of the analyst community, "which the SEC itself recognizes as necessary to the preservation of a healthy market" is diminished.

Was the SEC responsive to commentary regarding the rule?

I had no interaction with the SEC on Reg FD, and therefore have no opinion on this question. Based on my reading of the SEC's commentary on the regulation, it would appear that they were very responsive to the input of the media. I would also note that individual analysts generally have little interaction with the SEC, and it is my belief based on listening to the comments of several commissioners that the commissioners had relatively little direct interaction with practicing analysts in the formulation of the regulation.

How are those affected by Reg. FD adjusting to the Reg. FD regime in terms of policies, practices, and trends?

From an analyst perspective, Reg FD has had both positive and negative influences on how we conduct our business.

Increased emphasis on primary research
On the positive side, it has created a renewed commitment to what we call primary research. That is where we gather input from customers, vendors, competitors, employees, etc. to create a flow of information regarding a company's prospects.

Increased adversarial relationships between management and analyst
On the negative side, it has increased the adversarial relationship between managements and analysts. Many issuers now believe they need to protect themselves from analyst interactions. Many issuers are not particularly happy that analysts are poking more deeply into their relationships with customers, suppliers and even their lower level employees. Not all of these sources can replace the lost quality of information that was often available from direct interactions with top management, particularly surrounding longer-term strategies and estimate guidance.

In the post Reg FD world, analyst interaction with top management is far more likely to occur in a highly scripted manner, with management only discussing information that has been scrubbed and sanitized by lawyers and investor relations personnel. These interactions lack spontaneity and the depth of color that existed pre-Reg FD.

In some instances, management will only meet with analysts in large group meetings. Analysts are a competitive lot, and by their nature are reluctant to ask probing questions in front of their competition. We simply don't want our competitors to have the benefit of divining our "angle" on the stock from the kinds of questions we ask management.

Inconsistencies in what kinds of information companies release mid-quarter
On page C1 of *The Wall Street Journal* on May 11th, there was an article entitled "After Reg FD, Progressive Sets Bold Move." Here is a situation in which Reg FD can be interpreted as having its desired influence on issuer disclosure. Instead of publishing operating statistics only at quarter end, Progressive will now issue monthly statistics. This may force its competitors to do the same. That is clearly positive. But still, the data provided by Progressive is historical. They still refuse to give forward guidance on how they believe the company will perform. And even prior to Reg FD, Progressive had moved toward having quarterly earnings conference calls. The article also mentions how Progressive is not giving any commentary or analysis on their operating statistics and won't report investment income and tax rates—crucial data in evaluating a company.

The same article notes that Gillete announced earlier this year that it would no longer provide short-term earnings guidance. And a *New York Times* article on Saturday talked about how Wal-Mart will no longer share its detailed sales data with third-parties.

The *Journal* article states: "… many companies are puzzled buy just what 'material' means, and what Reg FD does and doesn't allow them to say. Many are uncertain of how best to deal with analysts are fearful they might overstep the bounds of the rule and incur the wrath of the SEC." I agree that the biggest problem with the

regulation is the lack of clarity on what is material versus non-material information. In the absence of that clarity and with a new degree of liability, many issuers have chosen to take the safe road of reducing the quality of information. So while the Regulation may have positive impact on the "fairness" of information dissemination, I believe it has had a negative impact on the "fullness" of information dissemination.

Reduction in quality information from management in 1-on-1 meetings and conversations
One of the ways issuers have responded to Reg FD is by avoiding have any discussion with analysts that could be remotely construed as having a bearing on earnings guidance. For example, the simple question "how's business?" often elicits the response "we have no new guidance from our previous press release." The very text of the SEC renders conversations with management difficult:

> "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." 65 Fed. Register at 51721 (August 24, 2000).

That language pretty much precludes all private conversations with an analyst, because an analyst who is any good at his or her job is always seeking information to go into their earnings estimates. It puts the issuer official in a predicament, because he or she cannot be sure what kernal of information will ex post facto be interpreted as material. What is perceived as a material fact to one analyst may be immaterial to another.

Any information that goes into an analyst's estimates under this language is material. And I have to tell you that essentially all information about a company, from how full the parking lot is, to how clean the CEOs desk is compared to how it normally is, to who signed the guest register to where a CFO is flying to can become material as the one piece of information that solidifies an analyst's view on the earnings outlook for the company. Any private meeting is by definition selective. If the consensus estimate for a quarter is higher than the guidance issued by an issuer in a previous press release, and the issuer merely says "we are comfortable with our previous guidance" they have technically violated the regulation by implying that their earnings will be lower than consensus.

Lack of insight on models and reports
Prior to Reg FD, it was a common but not universal practice for an analyst to send a preview copy of a research report to the issuer. The intent was to give the issuer a chance to comment on factual errors and to rebut any unflattering arguments made by the analyst. Of course, a good analyst used any management feedback only as one source of information. The preview also enabled management to be prepared for any inbound grief they might have gotten from investors. It was a courtesy.

Post Reg FD, many issuers will refuse to comment in any way on a preview report. I personally know of one issuer who refuses to even have an analyst fax him a report or model, because he doesn't want anyone to even try to assert that he ever commented on one. This is a small issuer who does not want to spend a lot of money trying to comply with Reg FD. Why would they take this position? I cite the following from the SEC website.

7. Can an issuer ever review and comment on an analyst's model privately without triggering Regulation FD's disclosure requirements?

Yes. It depends on whether, in so doing, the issuer communicates material nonpublic information. For example, an issuer ordinarily would not be conveying material nonpublic information if it corrected historical facts that were a matter of public record. An issuer also would not be conveying such information if it shared seemingly inconsequential data which, pieced together with public information by a skilled analyst with knowledge of the issuer and the industry, helps form a mosaic that reveals material nonpublic information. It would not violate Regulation FD to reveal this type of data even if, when added to the analyst's own fund of knowledge, it is used to construct his or her ultimate judgments about the issuer. An issuer may not, however, use the discussion of an analyst's model as a vehicle for selectively communicating – either expressly or in code – material nonpublic information.

Source: http://www.sec.gov/interps/telephone/phonesupplement4.htm

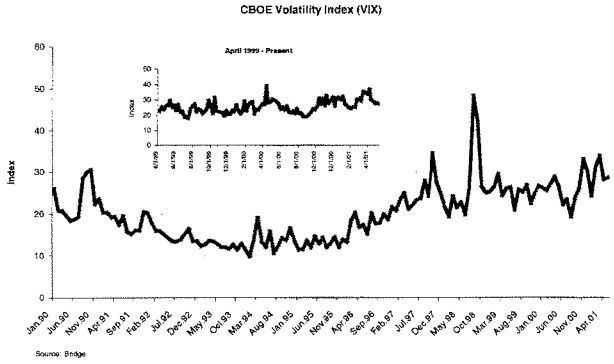
I would posit that it is impossible for an issuer to determine what the Commission means by "seemingly inconsequential data. When in doubt, it is safer just to say nothing. That is probably the advice they are getting from their attorneys. So analysts are lacking the nuance and color that they may have previously gotten.

In your view, has Reg FD impacted volatility in the marketplace, and if so, how?

I believe that, in addition to the costs of compliance, a primary cost of the Regulation has been increased volatility of the market. "Fairer" dissemination has reduced the "fullness" of dissemination. So the cost of fairness has been volatility. It is up to higher powers than me to determine whether the cost is worth the benefit, but I have been surprised by the lack of attention to this point.

While many factors go into creating more or less market volatility, I believe the volatility cost of Reg FD is something that can and should be studied and determined. Reg FD was implemented at an inflection point in the market. It also coincided with decimalization of stock quotes. Most stocks are down significantly from the date of its effectiveness. While the correction in the stock market is the result of declining fundamentals in the economy, not Reg FD, I do believe that the regulation contributed to volatility during this period, as the investing community has been deprived of information flows that could have injected a bit more certainty surrounding earnings estimates and business prospects.

One commonly used measure of market volatility is the CBOE Volatility Index, or VIX. This index clearly indicates an increase in the trend of market volatility since the introduction of the prospects of Reg FD in the summer of 2000. One might argue that since the VIX is based on the volatility of options on stocks, there are probably better measures of volatility and I would agree. It would take a more detailed study of individual stock price movements to get a real sense of true market volatility. This would make for a fine thesis for a doctoral candidate.



From my experience and study of economics, I have noticed that a reduced quality of information has reduced analysts' confidence in their estimates and interpretations. I note that while the range of street earnings estimates for the next quarter appear to have tightened up as analysts get more detailed near term information from the companies, the range of out year estimates has widened. Out year estimates are far more important to valuation determinations than just the next quarter. This situation implies much less confidence in the earnings outlook for a company and leads to more volatility.

What impact has Reg. FD had upon the quality and quantity of information being provided to the capital markets about issuer companies?

As previously noted, quantity is up and quality is down. Reg FD has not really changed the practices of professional investors in terms of what they read or which calls they listen to. On the margin, some individual investors appear to be taking advantage of new information conduits, but not in large numbers. I have found it ironic how few investors seem to be interested in all the incremental data that is now presumably available post Reg FD. Conference calls and webcasts for many, indeed most, companies are sparsely attended. This is particularly true for smaller issuers.

The sad fact is that most individual investors, when trading individual stocks, rely on the media for their investing data. Given that company press releases and conference calls are now lacking a level of analysis and color that they previously included, the investing public is left to get its information filtered by a reporter who is often selected more for on camera ratings potential than the depth or insight of their analysis. Do these financial reporters have degrees in economics, accounting or financial analysis? Have they passed the Series 7 exam? Are they Chartered Financial Analysts?

To the degree that Reg FD has reduced the insight available to the media in interpreting information, the public may be getting the short end of the stick.

What particular benefits or problems is your industry group experiencing as a result of Reg. FD?

Addressed above.

Are there any specific ways that Reg. FD can be improved?

In my view the regulation could be improved in the following ways:

- clarification regarding what is considered "material" information to end the ex post facto nature of the definition—particularly as it relates to earnings guidance by issuers
- a carve out for analysts on any derivative liability

Materiality
In general, reducing liability for disseminating information should improve the quality of information disseminated. Therefore, clarification on the definition of materiality would be helpful. The current definition of materiality in the rule is ex post facto (i.e., the information is material if it moved the stock price.) This is tautological and impossible to accurately anticipate. It brings to mind the comment "I don't know what art is, but I know it when I see it." In the absence of clarity, the natural impulse is to reduce information flow to the minimum disclosure required by law.

From this it follows that the definition of materiality should be as narrow as possible. In my view, this would encourage the broadest dissemination of the many pieces of information that analysts piece together in a mosaic to create our investment recommendations.

Enforcement
It is also very unclear as to how the Regulation will be enforced. I participated in an SEC sponsored round table in New York in April where one of the commissioners was emphatic that interpretations of materiality under the regulation would not be determined by enforcement cases. I also participated in a roundtable on the subject sponsored earlier in the year by Business Wire, where another commissioner said that the SEC did not intend to aggressively enforce the rule. Yet even as we speak the enforcement division of the SEC is making inquiries of a number of issuers and analysts about who told who what when. What is the investment community to believe? Actions speak louder than words.

I believe there should be a safe harbor for securities analysts to protect them from derivative liability under Reg FD. Such protection should apply as long as an analyst is in compliance with the Chinese Wall procedures required by Exchange Act Section 15(f), and that information did not improperly influence the broker-dealer's proprietary trading.

As noted in the SIA's testimony, 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 threatening." What is "abusive"? What is "threatening"? If an analyst is "abusive and threatening" to an issuer official, he or she is likely to have bigger problem that penalties under Reg FD. These kind of stretches by the Commission are just further examples that enforcement of Reg FD against securities analysts is impractical from any reasonability standard and could border on the farcical. Nevertheless, no analyst wants to risk having any sort of run in with the SEC on his or her U4. Having exposure to the risk of persecution under Reg FD for what many analyst see as their ethical duty to their clients does not encourage analysts to be determined in their probing.

I would note that the exclusion of the media from Reg FD puts them at an advantage over the analyst community in getting information from issuers. It is ironical that under Reg FD, instead of the supposedly "favored analyst" using unfairly garnered material information to favor their preferred clients, now favored media outlets and reporters can deliver material information to their preferred clients in what could be construed as a violation of the spirit of Reg FD. Reg FD has encouraged issuers to curry favor with the financial media.

Why not give analysts the same protections—the liability for Reg FD violations should remain with the issuer, not the analyst.

Dissemination

In my opinion, the dissemination requirements of the Regulation put small companies at a disadvantage. Until the SEC starts sending a synopsis of 8-K filings to the news wire services, most analysts and investors will rely on the media for timely dissemination of press releases. Media companies have little incentive to cover the press releases of small companies. Perhaps there should be an exclusion for the rule for issuer below a certain size or shareholder base.

Conclusion

In conclusion, it is my opinion that Reg FD has had a mildly positive impact on the public's perception of market fairness surrounding selective dissemination. However, I do not believe that selective dissemination was a significant problem prior to the regulation, and that the cost of the regulation has been high in terms of compliance costs and increased market volatility from the increased quantity/reduced quality of information available to professional investors.

I believe the Regulation should be modified to provide more clarity on the issues of materiality and enforcement in order to mitigate at least the volatility issue.

I thank the Committee for its invitation to testify.

Testimony of Thomas M. Gardner

Before the Subcommittee on Capital Markets of

the Committee on Financial Services

of the United States House of Representatives

May 17, 2001

I. Introduction and Background

Good morning. My name is Tom Gardner and I am co-founder of The Motley Fool, Inc., a multimedia personal finance company headquartered right across the Potomac River in Old Town Alexandria, Virginia. It is truly a pleasure to be before this subcommittee to talk about what equal access to information means to individual investors.

In 1994, my brother, David, and I started The Motley Fool as a newsletter with a mission to "educate, amuse, and enrich" the individual investor. In choosing a name for our company, we searched for something that would signify what we stood for: telling people the truth about personal finance and investing. In Elizabethan theater, the Fool was the only one who could tell the king the truth without getting his head chopped off.

Today, The Motley Fool educates more than 30 million people each month about personal finance and investing. We reach consumers and investors in more than 100 countries through our website, radio and television broadcasts, newspapers, and books.

Our work is driven by our belief that average people can benefit from taking a more active interest in the management of their money. In order to exercise this control, investors need education, information, the opportunity for dialogue, and an open platform for questions and answers. That's what we provide. We teach people the fundamentals of long-term financial management. We help them find the resources they need to become successful investors. And we provide a forum for a thriving online community that learns from each other 24 hours a day, 7 days a week, 365 days a year.

II. The need for a level playing field

But I'm not really here today as a business owner. I'm here because The Motley Fool represents people from all walks of life who go to work, earn money, and make decisions about the financial path their lives will take. Over the past eight years, we've heard from our members again and again about the importance of access to simple information - information about Einstein's miracle of compounding growth, information about the *real* (after-fee and after-tax) returns of managed mutual funds, information about any public company's quarterly earnings result. And, for investors, **access** to information means that, in a public market, this information must be available to **all** investors at the same time.

Protecting this simultaneous access to information has been and should continue to be a focus of the SEC in recent years. When Arthur Levitt became SEC Chairman in 1993, one of his main priorities was to establish a completely level playing field for all investors. Under his guidance, 1) the SEC required that prospectuses be written in "plain English" rather than in some foreign, obscure language; 2) the SEC sought to protect the integrity of the financial reporting process by requiring public companies to provide investors with information about their relationships with their auditors; 3) the SEC required mutual funds to report their results more clearly to their investors; and finally, and importantly, 4) the SEC passed Regulation FD to ensure that all investors, regardless of their geographic location, their professional standing, or the size of their brokerage account, got access to the same information at the same time.

And **that's** what I'd like to talk to you about today – the importance of maintaining and advancing the public nature of our markets.

III. The need for the public markets to be PUBLIC

Every day millions of investors put their money in the stock market and become *part owners* of companies and businesses they believe in. But besides just having the chance to become a business owner, every investor sets out with the goal to grow their assets and build their wealth.

Over the last 100 years, the stock market has provided the best long-term means to build our wealth. It's provided average annual returns of around 11% and has allowed us to put down payments on homes, to pay for our kids' educations, and to retire comfortably. And along the

way the *public* market has financed some pretty impressive businesses and led to the creation of products that have changed our lives. A company like Johnson & Johnson improves the lives of millions of people each year – and has done so for more than a hundred years – due in large part to its access to capital in the *public* markets.

The problem is that professional investors on Wall Street have increasingly tried to create private markets of information to benefit themselves and their firms. Selective disclosure by the mid-1990s was a primary source of what I consider to be illegal inside information and insider trading that Wall Street analysts and fund managers participated in. They received material information in advance of individual investors. And the evidence shows they acted on that information before the rest of the market encountered it.

The net result of private, preferred markets within our general public market is that smaller investors reduce their investments. Thinking the game is rigged, they pull back. They recognize that selective disclosure leads to "investing" that is not based on analysis, hard work, and intelligence but instead on who you know or how much money you can invest.

If we were to establish a capital market system today from scratch, wouldn't we prohibit selective disclosure? Wouldn't we want all investors, regardless of the size of their portfolio or their position relative to lower Manhattan, to get the same information from the companies they own? I can't imagine wanting any other sort of public market in a free country.

Shouldn't the soccer mom who is putting $100 a month into a dividend reinvestment plan for her child's college education have access to the same information at the same time as the fund manager who wears a nice suit, carries a bottle of Mylanta, and has to decide where to put his million dollars?

Selective disclosure undermines this equal access. Selective disclosure – a common practice on Wall Street for years – is a direct violation of the spirit and law of our public markets. It is a violation that should be of the highest concern to those who oversee the market – the SEC and the United States Congress.

When the federal securities laws were enacted in 1933, Congress gave the SEC a mandate to protect investors. Under this mandate, the SEC is obliged to protect **all** investors: technology investors in Silicon Valley; long-term investors in Omaha, Nebraska; patient investors in Gulfport, Mississippi; and professional investors on Wall Street. The SEC is obliged to protect all investors, regardless of who they may know, how much money they have to invest, and how well they might do. Any SEC action that contravenes this duty would naturally force us to ask why American citizens would pay tax money to fund a regulatory agency that might not protect those citizens' best interests.

IV. The fight against Regulation FD

Regulation FD dramatically changed the financial landscape this past year. It sought to protect all investors. It made the soccer mom and the analyst equal in the eyes of a public company and in the eyes of the law. And while many individual investors were surprised that selective disclosure wasn't already prohibited, analysts and institutional investors have attempted to use their influence and power to prevent the enforcement of Regulation FD. They are still fighting.

But they're not fighting Regulation FD based on its fairness to all investors. They must know it is fair. Instead they argue that Regulation FD prevents them from sorting through important information that they can then share with the rest of the marketplace.

As an individual investor, I am insulted by the implication that individual investors are not smart enough to flesh out the information they need without the help of an analyst. Every day, we see and talk to investors that take control of their personal finances and investment decisions and are quite successful. We also encounter a number of professional investors who use our forum to learn from the armies of researchers that gather at Fool.com.

To claim or even imply that individual investors need interpreters takes us back to the Middle Ages when the common man was forced to rely on the priestly class to interpret the Bible for him. The arrival of the printing press made more books available and gave common folks a first hand opportunity to interpret the Bible for themselves. Similarly, the Internet allows individual

investors to access, analyze, and act on financial information. I certainly don't see a need for professional investors to earn an illegal information advantage in order to then translate that information, on delay, for individual investors.

The argument that analysts benefit individual investors because they sift through information and help them decide what's important simply isn't true. We know that analysts are not neutral observers. We know that they're not objective sources. They work for big investment firms and shoulder the burdens of powerful interests. That's one of the reasons that only 1% of all analyst recommendations last year were "sell" recommendations. Why? Because analysts work at firms that broadly seek underwriting deals with public companies, and that renders the analyst a very subjective player in the public markets.

While we're talking about analysts, what exactly is an analyst, and why can't I, as an individual investor, be one? If I'm analyzing 10-K's, 10-Q's, and press releases, or if I'm talking with other investors or people from the company, aren't I already an analyst? Who determines which analysts get to sit on exclusive quarterly conference calls? Who determines which analysts gain access to private, closed-door meetings with company executives? Who determines which analysts get earnings guidance from the CFOs at public companies before the general public hears of it? I'd like to know. Because I, and tens of millions of other American investors, would officially like to sign up to be in that group.

Opponents of Regulation FD will that it has increased market volatility. However, they won't be able to provide any evidence. And even if they could, is it Congress and the SEC's

responsibility to reduce market volatility? Furthermore, how they define their studies of volatility should be of particular interest to those responsible for protecting all investors and preserving the public nature of our public markets. If a company releases bad news simultaneously to everyone and its stock falls from $30 to $25, is this any more volatile than if the company had selectively released information to professionals on Wall Street, who dropped the stock from $30 to $27, then released the information to the general public, who sold it down to $25? Keep your eyes focused on the time periods applied to these volatility studies.

Opponents of full disclosure will also argue that Regulation FD has somehow stifled corporate disclosure. Again, there will be no evidence to back up this claim. In fact, last Friday's *Wall Street Journal* reported that Progressive Insurance plans to start reporting financial information on a monthly, rather than quarterly, basis. Progressive's CFO saw Regulation FD as "an opportunity for us to open up more" to investors. Regardless, would we want more information if that information were protected for a privileged group of Wall Street investors? In a free country, wouldn't our public markets function more effectively with less information delivered fairly than more information delivered illegally?

V. Don't take Regulation FD away

The SEC received more than 6500 comment letters about Regulation FD, more comment letters than the SEC had ever received on a single proposal. A large percentage of those comment letters were submitted by individual investors at The Motley Fool. By our count, 50% of the comment letters were sent to the SEC on the days that we featured editorial content about the

issue in which we encouraged people to make their views known to the SEC. Our worldwide community of investors cares greatly about this issue.

Some of the letters contained detailed economic analyses of why the market could not function efficiently if selective disclosure were allowed to continue. Some of the letters simply stated that selective disclosure just wasn't fair and that it shouldn't matter who you know or how much money you have. A number of investors also expressed shock and surprise that Regulation FD wasn't already mandated. Over and over again, the point of these letters was the same: individual investors ought to be **entitled** to the same information at the same time as Wall Street investors. I am here today as a representative of that community of individual investors who voiced their desire for a level playing field. That community is invested in the market. Today, almost 50% of all U.S. households are exposed to the stock market, either directly or through mutual funds and retirement plans. That's more than double the number of equity investors fifteen years ago. It is clear that individual investors are a vital part of our public markets.

With that in mind it is important for the SEC and Congress to listen to individual investors who write:

> Imagine my horror when I found that regardless of the amount of research I did on a company in which I was a part owner, I could quite legitimately be kept in the dark about highly relevant facts that were released to a closed group of financial people with their own specific financial interests.

> Now that Regulation FD is in effect, I can do my own analysis on a level playing field with everybody else.

Selective disclosure compromises the integrity and efficiency of our markets and turns them from public markets, where everyone has the same access and opportunities, to private markets, where who you know and how much money you have are more important. This is not a principle on which our country was founded, nor should it be a principle of our market.

I'd like to close with a quote from former SEC Chairman Arthur Levitt that explains why he believes that preserving the public nature of our markets is extremely important to the integrity, confidence, and efficiency of those markets.

> Simply put, these practices defy the principles of integrity and fairness.... We teach our children that a person gets ahead through hard work and diligence... that through equal opportunity, everyone has a chance to succeed. America's marketplace should be no exception. Instead, it should serve as a beacon.

Thank you.

STATEMENT OF PATRICK D. SWEENEY

GENERAL COUNSEL

NOMURA CORPORATE RESEARCH AND ASSET MANAGEMENT INC.

ON

SECURITIES AND EXCHANGE COMMISSION
REGULATION FAIR DISCLOSURE
(17 C.F.R. PART 243)
"REG FD"

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

MAY 17, 2001

Executive Summary of Testimony of Patrick D. Sweeney

1. A widespread, ongoing practice of selective disclosure of *material* information by corporate issuers would erode public confidence in the fairness of the securities markets and should be corrected by an appropriate regulatory response.

2. The broad scope of Reg FD is premised upon the existence of widespread and abusive selective disclosure of *material* information by corporate issuers.

3. In assessing whether Reg FD appropriately responds to the problem of abusive selective disclosure, consideration should be given to the potentially adverse impact of the regulation upon the long established investor relations communication channels that support the fundamental analysis conducted by buy-side investment managers.

4. By persistently linking the rationale and methodology of Reg FD to insider trading concepts, the Commission appears to have provoked a conservative and overly cautious response on the part of corporate issuers to regulatory compliance.

5. Reg FD has already affected the quantity and timeliness of information provided by corporate issuers, and the adverse impact of the regulation on the fundamental analysis process may progressively worsen as analytical investment models become outdated.

6. The negative impact of Reg FD on market transparency is most apparent in the case of financially stressed or distressed corporate issuers.

7. Reg FD should be reevaluated generally, taking into account the empirical data employed by the Commission in determining the scope of the selective disclosure problem, as well as the potential detrimental impact of the regulation on the buy-side fundamental analysis process and other legitimate market processes.

8. Public disclosure requirements imposed on corporate issuers by Reg FD should be based upon the objective itemized reporting methodology of Section 13(a) of the Securities Exchange Act, rather than upon subjective and ambiguous determinations of materiality similar to those employed in determining liability for insider trading under Rule 10b-5.

Introduction

My name is Patrick D. Sweeney. I am the General Counsel of Nomura Corporate Research and Asset Management Inc., more commonly known as "NCRAM". NCRAM is a registered investment adviser based in New York City. It is a member of the Investment Company Institute, the national association of the American investment company industry. NCRAM manages client assets invested in high yielding corporate bonds and other securities issued and traded in the U.S. capital markets. At February 28, 2001, NCRAM managed client assets with an aggregate market value of approximately $2.3 billion. A significant portion of NCRAM's clients are mutual funds organized and sold to retail investors in the United States and other major capital markets. While mutual funds themselves are correctly viewed as institutional investors, they are typically offered to the public retail investor markets and draw capital investments from millions of retail investors.

Like many other "buy-side" investment managers, NCRAM employs its own team of research analysts to support all investment decisions made by NCRAM on behalf of its advisory clients. Such "buy-side analysts" should be distinguished from "sell-side research analysts" employed by investment banks, broker-dealer firms and similar institutions to provide research and analytic support for corporate investment banking engagements, investment recommendations to firm customers, and related functions. By contrast, as a buy-side investment manager, NCRAM works solely for its advisory clients and continually engages in a fundamental analysis of the business and financial risk of

each corporate issuer in which it has invested or proposes to invest on behalf of its advisory clients. As part of this fundamental analysis, NCRAM evaluates the issuer's management experience, market position, cost structure, historical track record and cash flow generating ability. The process regularly undertaken by NCRAM's analysts involves not only a review of the company's published financial information, but also incorporates one-on-one visits with company management, discussions with industry analysts, visits to company facilities and consultation with third party experts as appropriate.

The ability of NCRAM, and of many other buy-side investment managers, to conduct fundamental investment analysis is a key variable in the quality of investment services provided to retail investors in mutual fund advisory accounts. Fundamental analysis on behalf of mutual funds provides a significant investment benefit which most retail investors would be unable to achieve with their own resources.

Comments

It is from these perspectives that I am pleased to have the opportunity today to make the following comments on Reg FD:

1. **A widespread, ongoing practice of selective disclosure of *material* information by corporate issuers would erode public confidence in the fairness of the securities markets and should be corrected by an appropriate regulatory response.** Buy-side investment managers recognize the importance of Commission rule-making and enforcement

efforts under Section 10(b) of the Securities Exchange Act of 1934 to prevent the misuse of material non-public information in the public securities markets. Registered investment advisers are specifically obliged, under Section 204A of the Investment Advisers Act of 1940, to prevent the misuse of material non-public information in their possession. With these concerns in mind, the protocols of investor relations communications between corporate issuers and buy side investment managers have been carefully structured over the years to limit communications to *non-material* information, which can be used by buy-side analysts to structure proprietary investment models for corporate issuers. This practice is consistent with the long-recognized "mosaic theory," which enables an investment manager to develop and implement independent investment decisions based upon its analysis of discrete, non-material pieces of information provided by the corporate issuer.

2. **The broad scope of Reg FD is premised upon the existence of widespread and abusive selective disclosure of *material* information by corporate issuers.** In determining whether Reg FD is an appropriate regulatory response to the problem, it would be helpful to understand more clearly the empirical data supporting this premise, none of which was included in the proposing and adopting releases.

3. **In assessing whether Reg FD appropriately responds to the problem of abusive selective disclosure, consideration should be given to the potentially adverse impact of the regulation upon the long established**

investor relations communication channels that support the fundamental analysis conducted by buy-side investment managers. Although the adopting release refers several times to the role of analysts in the selective disclosure regime under question by the Commission, it is clear from the context that the Commission is referring to sell-side analysts responsible for securities recommendations. It is troubling that a regulation with such a potentially intrusive impact upon the long established communication channels between corporate issuers and buy side investment managers would be promulgated in the absence of a thorough examination of the potential ramifications for the fundamental analysis process and for the mutual fund investors who benefit from it.

4. **By persistently linking the rationale and methodology of Reg FD to insider trading concepts, the Commission appears to have provoked a conservative and overly cautious response on the part of corporate issuers to regulatory compliance.** Despite the repeated disclaimers of the Commission and several of its staff members, the adopting release repeatedly links the rationale for Reg FD to insider trading theories, stating, for example, that the "economic effects of the two practices are essentially the same," and prominently citing comment letters from individual investors to the effect that "selective disclosure was indistinguishable from insider trading in its effect on the market and investors". Even more significantly, the Commission has discarded the methodology of itemized reporting requirements under Section 13(a) of

the Securities Exchange Act (under which statutory provision the regulation is theoretically promulgated) in favor of a Rule 10b-5-like standard of accountability for disclosure of "material" information, whatever that may turn out to be in hindsight. Predictably, corporate issuers have determined, with the support of their counsel, to err on the side of discontinuing or truncating communications with analysts, particularly on a "one-on-one" basis.

5. **Reg FD has already affected the quantity and timeliness of information provided by corporate issuers, and the adverse impact of the regulation on the fundamental analysis process may progressively worsen as analytical investment models become outdated.** Although one-on-one calls and group investor calls continue, less information is provided, and in a less timely manner. Corporate issuers have traditionally assisted buy-side analysts in the construction of investment models for the issuers by providing historic "building block" components of revenue, expense and margin data, none of which would be considered material non-public information at the time the issuer shared it with the analyst. In our experience, a significant number of corporate issuers have either discontinued or curtailed this practice since the promulgation of Reg FD. We attribute that interruption of information flow to the expansive emphasis by the Commission on the abuses of earnings guidance, and the resulting fear of corporate issuers that selective disclosure of any information used by analysts to construct earnings models may

subsequently be required to be disclosed publicly. Regardless of the reason, the inability of analysts to refresh their investment models from time to time with more current historical information of this nature (or to create new models for new issuers) will inevitably impact the quality of fundamental analysis performed for mutual fund clients.

6. **The negative impact of Reg FD on market transparency is most apparent in the case of financially stressed or distressed corporate issuers.** Well managed, financially stable corporate issuers have generally attempted to cope with Reg FD restrictions in the context of one-on-one meetings and other traditional means of investor relations communications. In striking contrast, however, financially stressed and distressed companies generally appear to have shut down communications channels with buy-side investment managers, citing "Reg FD restrictions". In many cases the financially troubled company refrains from communicating with the capital markets in any manner until the company actually defaults on its debt or files for bankruptcy. Quite predictably, the capital markets operate to punish this lack of transparency by devaluing the company's publicly traded securities and further reducing the financial flexibility of the company to resolve its problems outside of bankruptcy. While it would not be fair to blame the current dramatic increase in corporate defaults and bankruptcies on Reg FD, it is nonetheless evident that many managers of financially troubled companies have relied upon

the ambiguities in the regulation to avoid accountability to buy-side investment managers, at significant cost to the companies' investors.

Recommendations

1. **Reg FD should be reevaluated generally, taking into account the empirical data employed by the Commission in determining the scope of the selective disclosure problem, as well as the potential detrimental impact of the regulation on the buy-side fundamental analysis process and other legitimate market processes.** Providing retail investors with more direct access to corporate earnings guidance is of course a positive development. However, a regulation which achieves this result by inhibiting the construction of investment models used to benefit the mutual fund investor must be seriously examined.
2. **Public disclosure requirements imposed on corporate issuers by Reg FD should be based upon the objective itemized reporting methodology of Section 13(a) of the Securities Exchange Act, rather than upon subjective and ambiguous determinations of materiality similar to those employed in determining liability for insider trading under Rule 10b-5.** This recommendation was developed in detail in the comment letter of the Investment Company Institute dated April 27, 2000, a copy of which is attached hereto, to which NCRAM and numerous other members of the investment management community contributed. Such a

revision of Reg FD would give corporate issuers clear guidance as to permissible areas of private discussion with buy-side analysts and should eliminate the *in terrorem* impact of the regulation.

Conclusion

NCRAM appreciates this opportunity to testify before the Subcommittee. Reg FD is a laudable effort of the Commission to maintain investor confidence in the integrity of the securities markets. More work is needed, however, to ensure that the scope of the regulation does not produce unintended and detrimental marketplace consequences. We are prepared, in collaboration with the Investment Company Institute and many of its other members, to continue to work with the Congress and the Commission to achieve the proper balance of market efficiencies and regulatory constraints with respect to the issue of selective disclosure.

INVESTMENT COMPANY INSTITUTE

CRAIG S. TYLE
GENERAL COUNSEL

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

[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").

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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

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[3] *Id.* at 72592.

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

[5] *See* Proposing Release at 72593.

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

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[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.*

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:

(a) Earnings information after the close of a fiscal quarter and before announcement of results;

(b) Mergers, acquisitions, important joint ventures or significant changes in assets;

(c) Filing for bankruptcy or appointment of a receiver;

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[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.").

(d) Change in auditors;

(e) Auditor notification that the company may no longer rely on the auditor's audit report;

(f) Significant developments regarding a major supplier or customer;

(g) Significant credit agreements;

(h) Default on significant loan covenants;

(i) Default on senior securities;

(j) Hiring, dismissal, resignation or death of the company's Chief Executive Officer, Chief Financial Officer, Chief Operating Officer or other comparable members of senior management;

(k) Adoption of a repurchase plan;

(l) Important legal proceedings, other than routine proceedings incidental to the business, involving claims exceeding ten percent of the issuer's assets;

(m) Significant new products or services; and

(n) Significant change in dividend amount.

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

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

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

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[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

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.

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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.

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]

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[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* note 19, 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 §10(b) 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* note 19, 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.*

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.[23] 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[24] is intended to set parameters for when "family or personal relationships create 'duties of trust or confidence' under the misappropriation theory."[25] 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."[26] 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.[27]

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[23] 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.

[24] 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).

[25] *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.

[26] *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).

[27] *See* Proposing Release at 72604.

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.

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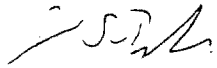
The Institute appreciates the opportunity to comment on these important rule proposals. If you have any questions regarding our comments, please contact the undersigned at (202) 326-5815, Amy Lancellotta at (202) 326-5824, or Dore Zornada at (202) 326-5819.

Sincerely,



Craig S. Tyle
General Counsel

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[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.").

Testimony of
Daniel P. Hann
Senior Vice President and General Counsel, Biomet, Inc., Warsaw, Indiana
on behalf of
The Association of Publicly Traded Companies

Before the

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Financial Services Committee
United States House of Representatives

May 17, 2001

Good morning Chairman Baker, Ranking Member Kanjorski and members of the Subcommittee. Thank you for the opportunity to testify today on behalf of the hundreds of mid cap and small cap public companies that make up the Association of Publicly Traded Companies ("APTC").

I am Daniel Hann, Senior Vice President and General Counsel of Biomet, Inc. Biomet is in the business of manufacturing and marketing products used primarily by orthopedic surgeons and is headquartered in the industrial heartland of northern Indiana. We have operations in over 40 locations worldwide and distribute products in more than 100 countries. Our best known product lines are total hip and total knee replacements for patients affected by osteoarthritis and osteoporosis.

Biomet has been a member of the APTC for many years and our President and CEO, Dr. Dane Miller, serves on the board of the APTC. With a market capitalization of approximately $7.8 billion and annual sales in excess of $1 billion we are no longer a small company, but we are still very much a growing company. We are proud of our reputation for creating and maintaining shareholder value. Dr. Miller was recently recognized by *Business Week* and *Forbes* magazines as among the top five CEOs in the country for delivering shareholder value relative to his compensation.

Biomet has been a public company since 1982. Our shareholders include some of the country's largest institutional investors as well as tens of thousands of individual investors. With regard to shareholder relations and corporate governance, we focus on long-term investors, many of whom are individuals. In addition, due to the success of our broad-based stock option plan, our shareholders include many of our own Biomet team members.

For all these reasons, Biomet and the APTC support the goal of promoting investor confidence through fair and efficient capital markets. The APTC's position on the specific issues before the Subcommittee is guided by a belief that issuers, investors and all market participants benefit from governmental policies that are designed to maximize the flow of quality information to the equities markets. Last month I had the opportunity to participate in the Regulation FD Roundtable held by the U.S. Securities and Exchange Commission (the "Commission") in New York City. Although we continue to believe there is room for improvement, the APTC applauds the efforts of Acting Chairman Unger and the other Commissioners to understand the full impact of Regulation FD and their willingness to provide guidance to market participants.

As a general matter, the APTC views Regulation FD as reflecting two policy choices. First, the decision not to create a new private right of action was a crucial and essential policy choice for Regulation FD and we commend the Commission for this wise decision. Second, the Commission decided that the benefits of a more level playing field for information outweighed the possible costs of restricting selective disclosure as it can be argued that any restrictions on the quantity or quality of information could negatively impact the efficiency of the stock markets. Insofar as Regulation FD has some positive aspects for issuers that may offset the additional burden of

compliance, we, as issuers, are relatively neutral toward it. For investors, however, -- especially long-term, buy-and-hold investors -- Regulation FD appears to be a mixed bag. Investors may feel that they are treated more fairly because it is unlawful for an issuer to provide material non-public information to someone who can trade ahead of them. However, unless individuals are attempting to beat professional traders in the day-by-day moves of the market, they would probably be better served by polices that promote more efficient markets, rather than focusing on an illusive level playing field.

Responses to the Subcommittee's Specific Questions

What impact has Regulation FD had on the quality and quantity of information being provided to the capital markets about issuer companies?

The overall quantity of information has not changed according to the two surveys of which we are aware, namely, the National Investors Relations Institute and the PricewaterhouseCoopers surveys. We believe that this is true because companies are issuing more press releases as a shield against the risk that a non-public disclosure could prove in hindsight to have been material. However, we believe that the quality of information has been adversely affected by the requirement for public disclosure of all material information. Such a requirement encourages issuers to limit disclosures to more general information that is less likely to become the basis of a private securities class action lawsuit if the company stock hits a downdraft. While we are unaware of any effort to measure it, we suspect that the quality of information going to the markets has suffered. I will offer a suggestion later as to how that impact might be mitigated.

Has Regulation FD impacted volatility in the marketplace?

It is difficult to say whether Regulation FD has caused more volatility in the equities markets. It is clear, however, that the long-term investors who sell stock when they need liquidity rather than when they think they have maximized their return would benefit from improved market efficiency and less volatility. If the net effect of Regulation FD is indeed "fairer" but more volatile markets, it could be a bad bargain for individual investors. However, to be frank, the net effect of Regulation FD will be evident only after the passage of more time.

What particular benefits or problems is your industry group experiencing as a result of Regulation FD?

The real benefit of Regulation FD inures to people like me, namely, lawyers. We now have a rule to reference when we caution others to avoid certain means of communication and disclosing certain types of information. We, the lawyers, are now more important and more necessary in publicly traded companies. I am certain the Subcommittee members – at least those who are lawyers -- applaud this result.

Seriously, the primary problem is uncertainty. No company wants to serve as the enforcement test case for Regulation FD. While we appreciate the statements from the Commissioners and the Commission's senior enforcement staff that they will not prosecute good faith mistakes, the vagueness of the materiality standard calls for caution. This is especially true for the large majority of publicly traded companies that lack a large staff of legal and communications personnel. There is a natural inclination to err on the side of caution pending some clarification as to where the Commission will draw the line on "materiality."

There is also a disproportionate impact on small and relatively new public companies. These companies often struggle to establish and maintain coverage by securities analysts. The new rule's prohibitions against "non-intentional" disclosures and one-on-one conversations with analysts will disproportionately burden smaller public companies. It is a simple function of human nature that an analyst with only marginal interest in a company will react negatively to being told, "Let me get back to you on that question after I talk to my lawyer."

Are there any specific ways that Regulation FD can be improved?

Yes. We offer two suggestions. One suggestion focuses on improving Regulation FD itself, while the other is based on a more practical way to overcome some of the unintended consequences of Regulation FD.

Our first proposal focuses on the problem that the legal definition of materiality is vague and fact-specific. When the Commission proposed Regulation FD, it offered no guidance as to how the Commission would define "material" for the purpose of this new rule. Nor did the proposing release ask for comment on whether there should be better guidance with regard to defining "material."

Because the materiality standard is the basis for enforcement, companies are generally responding by providing less information in non-public communications and providing more information of a general nature in a more structured format. The decline in more specific information probably harms the overall quality of information in the market. There is a solution to this problem, which could cure the principal defect in Regulation FD. The flow of information to the markets might well continue unabated, despite the new risk of enforcement action, if the rule were made clear and the risks were more well-defined. A bright line around the information the

Commission views as critical to the investing public in the context of Regulation FD will better serve the purpose of the rule than a purposefully vague materiality standard.

Since only the Commission will enforce this rule, the Commission should be able to state the types of information that are sufficiently material to prompt an investigation. We suspect that the Commission had determined the kinds of important information that were being disclosed selectively when it proposed the rule. A clear description of this information and similarly important types of information would serve clear notice on issuers and information recipients alike, and would justify vigorous enforcement of the new rule by the Commission.

Our second proposal is for more emphasis on another important area where the Commission can use other tools to promote the goal of Regulation FD – more and better information for all investors. Specifically, the Commission can promote a freer flow of information by supporting the statutory safe harbor for forward-looking statements or by promulgating a broader and deeper safe harbor under authority granted in the Private Securities Litigation Reform Act of 1995.

As I noted earlier, companies are now very cautious about making the types of specific forward-looking statements that will be most useful for individual investors. I offer the following example to explain how this works:

> Aware of the potential exposure to liability if a statement proves false and is arguably not forward-looking, a retail company's spokesman says: "The ongoing economic downturn is not likely to have a significant impact on our sales revenue." This is a fairly general and definitely forward-looking statement. It might not mean much to the average

> investor; however, an analyst who really understands the company's business might suspect that this means that "the company has surprisingly strong same-store sales so far and any imaginable drop would not keep the company from meeting its projections." If the company were comfortable, from an exposure perspective, with actually saying what the sophisticated analyst heard, all investors would benefit from clearer, more specific information. However, the company would not say this because the statement is partially comprised of "current" facts and may not be covered by the safe harbor.

Currently, companies that wish to communicate their expectations about the company's future must do so under the watchful eyes of their securities lawyers. Despite reform legislation, private securities class action lawsuits are still quite common if a company's stock experiences a significant drop. In addition, the safe harbor for forward-looking statements is still a work in progress in the federal courts. The Commission could be a positive force for improving the quality of forward-looking disclosures if it supported a more expansive interpretation of the safe harbor as *amicus curiae.* The Eleventh Circuit case, *Harris v. Ivax,* shows the way the safe harbor can provide real protection to issuers who offer meaningful information to investors in a public forum. Incidentally, in 1999, the Commission filed an *amicus* brief in that case that was not helpful to the broader interpretation of the safe harbor.

The Commission also could use its rulemaking authority to create a safe harbor that is clear enough that both issuers and investors can make good use of the information. Before the statutory safe harbor was enacted, the Commission engaged in an extensive rulemaking, during which it received many thoughtful comments and proposals. The Commission did not act

on those comments and proposals, but could revive that rulemaking to explore ways to encourage the disclosure of better quality forward-looking information.

It is certain that Regulation FD has changed the way many companies communicate with the markets. A better safe harbor also could change company communications for the better.

Was there a need for Regulation FD prior to its promulgation?

Regulation FD did not arise overnight. Selective disclosure has concerned the Commission for at least a decade. Even before Regulation FD was proposed, significant progress had been made in the simultaneous availability of important information to all investors. The availability of cost-efficient conference call technology and Internet webcasting had already begun a process whereby more and more public companies were opening their quarterly conference calls to all investors. In the years before the Commission proposed Regulation FD, Chairman Levitt and Commissioner Unger had a particular impact in raising the awareness of abusive practices that can result from selective disclosure. In fact, Regulation FD does not change the underlying law and, therefore, there is a reasonable question whether Regulation FD was a solution in search of a problem.

As the APTC's board discussed its reaction to Regulation FD over a period of weeks, it decided to support the Commission's overall effort toward involving issuing companies in efforts to eliminate the abuses of selective disclosure. The APTC board supported Regulation FD in concept when it was proposed by the Commission. As always, we will support vigorous enforcement against those who violate the Commission's rules in ways that harm investors and impugn the integrity of the public equities markets.

However, we thought then, and now, that more study and more opportunity for the free market to address the issue was advisable.

How are those affected by Regulation FD adjusting to the Regulation FD regime in terms of policies, practices and trends?

Regulation FD has significantly changed the way issuers deal with the investment community. It has not only had a significant impact on how companies communicate with analysts, it also has had an impact on how companies communicate with all market participants including, but not limited to, shareholders, employees and customers. In my experience, issuers have made a bona fide attempt to be good corporate stewards and comply with the new rule. In recent months, issuers have worked very hard to implement new policies and procedures to comply with Regulation FD and have taken steps to educate directors, officers and employees as to their respective duties and responsibilities under the rule. One consequence of the new rule is that issuer press releases tend to be longer and more detailed, oftentimes making it difficult for the average investor to separate the wheat from the chaff.

As a general rule, companies are now webcasting their conference calls and opening them up to the public rather than limiting these calls to analysts. During these calls, issuers are providing more detailed information, but far less original information as compared to what was

reported in the related press release. Accordingly, issuers are participating in fewer one-on-one meetings and telephone calls with analysts and shareholders and are unwilling to privately reaffirm an analyst's prior earnings guidance or, for that matter, even the company's prior guidance. The net result is that the rule seems to have had a chilling effect on investor relations as a whole.

Was the Commission responsive to commentary regarding the rule?

The Commission, both commissioners and senior staff, were very open to meetings and discussion about the rule. They met with APTC board members on a number of occasions to discuss the rule. The final rule attempted to respond to our concerns about the materiality standard without accepting our view. It also included a specific rule regarding earnings guidance, which provides a relatively bright line in one area. Therefore, the Commission attempted to respond to particular comments.

The Commission also received very persuasive comments urging the wisdom of more study and a more incremental approach. In this respect, the Commission was less responsive and today we are left with a controversial rule. Nevertheless, with the continued efforts of the Commission to be open to change and the adoption of the APTC's proposed solutions, I believe there is an opportunity to substantially improve Regulation FD.

In closing, once again I would like to thank you for the opportunity to appear before this Subcommittee and share the views of the APTC on Regulation FD.

Testimony of Stuart J. Kaswell
Senior Vice President and General Counsel,
Securities Industry Association
Concerning Regulation FD

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

May 17, 2001

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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.

[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

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[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]

Dissemination Techniques. 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.

Earnings Guidance. 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 advisory statement, it is likely that virtually all off-the-record discussion about earnings

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

[11] *Id.*

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

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 inadvertent disclosure over the weekend, they would need to consult the appropriate

[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.

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,

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

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.

Conclusion

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.

STATEMENT OF COMMISSIONER PAUL R. CAREY
REGARDING REGULATION FD
BEFORE THE
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES SUBCOMMITTEE
OF THE
HOUSE FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES
MAY 17, 2001

Chairman Baker, Congressman Kanjorski, Members of the Committee, thank you for asking me to share my views on Regulation FD with you. I regret that I am unable to appear before you today, but appreciate the opportunity to submit my thoughts for your consideration.

Like many, both in the industry and at the Commission, I was initially skeptical about how well Regulation FD would work in practice. Regulation FD signalled a significant sea change in how public companies would disseminate material information. The old system, where company insiders shared earnings and other important information with a small circle of analysts and institutional investors, had existed for a long time. After the Commission proposed Regulation FD, we heard from thousands of securities industry participants, many of whom predicted negative consequences to the markets were FD to go effective. While many of the arguments these commenters put forward were well reasoned and persuasive, I found it difficult, however, to refute the underlying premise of FD: that all investors, large and small, should have equal access to material information about a public company at the same time. How could we as a regulatory body continue to justify favoring a privileged few with advance notice of material news like earnings declines, new lines of business or dividend surges? Why should a few investors have the opportunity to trade on the news before it reached the market? With these principles in mind, I voted for Regulation FD, but agreed with my colleague, Commissioner Hunt, that we should closely monitor how well FD worked in practice.

How well is Regulation FD working?

As you know, the rule went effective in October. It is now May. So, what can we say about the effect of Regulation FD? From my perspective, I think we have seen many positive signs that the rule is working and is working amazingly well. But, I also firmly believe that it is too soon to draw too many conclusions. I think we need at least a full year's experience with Regulation FD before we can really evaluate its strengths and weaknesses and determine whether any modifications are needed.

The Commission recently held a roundtable on FD, inviting representatives from issuers, analysts, information disseminators and investors to share their experiences with us. Depending on whom you asked, FD has either resulted in qualitatively and quantitatively more, or less, disclosure. And both answers likely are correct. But, as many panelists

frankly admitted, both answers seem more drawn from anecdotal experiences than hard data. Representatives from the newswire services say they have seen the flow of news from public companies increase dramatically, commending the Commission for democratizing the disclosure process through FD. Since FD went into effect, the number of press releases issued, webcast announcements posted, web conferences and conference calls opened to the public and Form 8-Ks filed with the Commission appears to have risen considerably.

Analysts, however, will tell you that they must now work harder to obtain company information, and that companies are more reluctant to comment on analyst models or assist analysts in making or confirming their predictions. I do not think that it necessarily is a bad thing that analysts are researching more before publishing predictions. But, we certainly want analysts to have enough reliable information upon which to base responsible commentary. We've seen nothing yet to suggest that the quality of analysts' work has declined as a result of FD, but we need more experience with how company practices evolve in response to FD before we can fairly evaluate the impact of FD on the role of the analyst, or on the markets overall.

Institutional investors, like portfolio managers, tell us that they, too, have noticed a difference in how they obtain information from issuers. So far, they tell us that they still do their jobs well. Clearly, FD was meant to increase, not staunch, the flow of reliable material information to any segment of the investing community. Not surprisingly, individual investors, who now are accessing issuer conference calls and web conferences in unprecedented numbers, seem to like Regulation FD.

We also have heard concerns, as you must have as well, that FD may be contributing to some of the market volatility we have seen in recent months. Volatility is a complex issue, and we all can identify many factors that may have contributed to recent price fluctuations. What we have heard about FD's possible contribution to volatility is largely based on instinct rather than empirical research, but should not be idly dismissed. We have seen the market undergo change in recent months. No one is surprised to see the market, or a segment of the market, move downward in reaction to news that companies have failed to hit earnings targets. One panelist at our roundtable suggested that decimalized trading helped lower spreads and perhaps increased volatility, as had block trading in the sixties, program trading in the eighties and day trading in the nineties. This panelist advised that we do nothing, and wait for the market to sort things out as it has done well so many times in the past. As this panelist noted, volatility is not a new thing; we saw volatility before FD, and we, no doubt, will see it again long after the controversy surrounding FD has faded.

Obviously, we will want to explore the volatility issue further once we have more experience with the rule. But, I think it is also important to step back and examine how this rule could lead to volatility, and, if it did, whether a return to the practices of the past would be advisable. Does anyone really believe that it would be preferable to allow a class of analysts and large investors to learn of good or bad news and trade accordingly, in advance of the rest of the market, in order to more gradually move the market up or down? Does

anyone really believe that these privileged few should be able to profit by trading before the market, and the retail investor, have a chance to learn and absorb the new material information?

What more should the Commission be doing?

While I cannot stress enough that it is too soon to fully and fairly evaluate the viability of Regulation FD, I do not mean to suggest that the Commission or its staff should sit idly by waiting for FD data to collect. The Commission and its staff have been actively seeking input from the industry at conferences and at forums like the recent Commission roundtable. Our Corporation Finance staff has been fielding telephone calls from industry participants seeking guidance or clarification about how the rule should work in practice. Corporation Finance has twice published answers to frequently asked questions so that the whole industry can benefit from the telephone interpretations the staff has been giving. I would expect and anticipate that this practice would continue. Many roundtable participants asked for additional guidance on issues such as: what constitutes an intentional disclosure for purposes of the rule; and what types of dissemination would satisfy the rule. Through our continuing dialogue with the industry, we hope to provide further assurance about how to comply with this rule.

Is the threat of an FD Enforcement action chilling communication?

In the interim, we have heard issuers voice concern about the specter of facing an FD enforcement action. In speeches and as part of our industry outreach on FD, we have assured the industry that the Commission does not intend to bring an enforcement action against an issuer who is making a good faith, reasonable effort to comply with the rule. FD is not meant to be a trap for the unwary.

Clearly, we do not want the fear of an enforcement action to chill dissemination of information. The rule was designed to enhance, not inhibit, disclosure of material information. To those who continue to doubt that we mean what we say regarding enforcement, look at our record. We have yet to bring an FD enforcement action. And, I, for one, at this early stage in our collective experience with Regulation FD, would be very reluctant to support an FD enforcement action based on a mere technical violation where an issuer made a good faith, reasonable attempt at compliance.

What type of dissemination should satisfy FD?

I have saved for last an issue that I feel very strongly about and that is: what method of dissemination should satisfy the FD disclosure requirement? The rule text allows issuers to use a combination of methods reasonably designed to achieve a broad, non-exclusionary distribution of the information to the public. I have two points to make on this issue. First, the digital divide still exists; it would be an anomalous result if a rule designed to democratize the flow of information to all investors resulted in disenfranchising one or more

categories of investors. Second, this is one area where I do not believe that one size fits all. In other words, there is not one method of dissemination that will work equally well to satisfy the rule for all issuers.

With respect to the digital divide issue, some securities industry participants have advocated for web-only disclosure. The FD release is clear that we did not intend to supplant stock exchange rules that require issuers to disclose certain material information in a press release. Thus, information that the stock exchanges customarily have required to be disseminated in a press release, like earnings information, should continue to be disseminated in a press release. Additional material disclosures made in a follow-up conference call or webcast that has been well noticed and made accessible to the public do not have to be included in a press release, but the information that traditionally has been included in a press release should continue to be so included. Clearly, computer access and web access are the waves of the future. One day soon, I hope that all investors will have ready access to the Internet. Each year, the numbers of American households owning computers and having the ability to access the Internet increase. But, computer ownership and/or web access are not yet universal. A recent Commerce Department survey reports that 41.5% of U.S. households have Internet access. We will get there; we simply aren't there yet. And I, for one, am not comfortable disenfranchising the less well-heeled investor or the less-technologically advanced investor. I do not believe that the questionable burden of continuing the earnings press release disclosure is sufficient to outweigh the benefits that it provides to investors. I view the continuation of the earnings press release disclosure as transitional, but necessary, disclosure.

As for my second point, when the digital divide narrows, webpage-only disclosure may never be adequate for certain companies. Website disclosure made by the large, well seasoned issuer with a large analyst or news media following will be picked up and absorbed rapidly by the market. The same absorption is unlikely to occur for the small, start-up company with little or no analyst or news media following. One commentator recently analogized the start-up companies' webpage-only disclosure to the tree that fell in the forest with no one around to hear the fall. This means that newer, smaller companies may have to undertake a combination of efforts to disseminate material information until they have a sufficient following to use a more streamlined disclosure process. This disclosure approach is not unprecedented. It is somewhat similar to our registration process: larger, more seasoned issuers are able to use the more streamlined shelf registration process, while newer smaller companies must use a more extensive registration document.

Thank you again for allowing me to share my views with you. Again, I apologize that I could not attend this hearing in person. I would be happy to respond to any questions or comments from any members of the Committee.

1399 New York Avenue, NW
Washington, DC 20005-4711
Telephone 202.434.8400
Fax 202.434.8456
www.bondmarkets.com

40 Broad Street
New York, NY 10004-2373
Telephone 212.440.9400
Fax 212.440.5260

St. Michael's House
1 George Yard
London EC3V 9DH England
Telephone 44.20.77 43 93 00
Fax 44.20.77 43 93 01

Statement of The Bond Market Association

Before the
United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Hearing
Fair Disclosure or Flawed Disclosure: Is Regulation FD Helping or Hurting Investors?

May 17, 2001
Submitted for the Record

The Bond Market Association is pleased to submit this statement on the effect of Securities and Exchange Commission's Regulation FD on the market for high-yield corporate bonds. The Association represents securities firms and banks that underwrite, trade and sell bonds in the international and domestic markets. Our membership represents the top underwriters and dealers of high-yield bonds and collectively accounts for more than 95 percent of nation's overall bond underwriting activity. We commend Chairman Baker for holding this hearing and appreciate the opportunity to present our views.

Regulation FD was designed to encourage issuers to make full and fair disclosure of material information on a non-selective basis. The Association supports this goal and opposes the practices Regulation FD was designed to address. In earlier comments to the SEC on a draft version of Regulation FD, the Association agreed with the need to end selective dissemination of material, non-public information that is intended to confer a benefit or preference.[1] At the same time, we expressed concern that the requirements of Regulation FD could hurt the flow of information in the market for high-yield bonds. This would, in turn, create difficulties for businesses seeking to raise capital through offerings of high-yield bonds.

Our members' initial experience with Regulation FD suggests the new disclosure requirement, while beneficial in some respects, has had generally negative consequences

[1] Letter from Irshad Karim, Chair, Corporate Bond Legal Advisory Committee, The Bond Market Association to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Apr. 28, 2000).

for the high-yield bond market that merit continued monitoring. During the six months following the implementation of Regulation FD, the Association has observed the following:

- The volume and quality of the information made available by issuers in the high-yield marketplace has declined, and effective analysis of matters with particular relevance for investors in high-yield bonds has become more difficult as a result;
- The price volatility of certain segments of the market, especially the high-yield bonds of smaller businesses, may have increased, and the liquidity of certain bond issues may have decreased, as a result of changes in the flow of information to the marketplace; and
- Private placements of high-yield bonds have required increased time and expense, particularly in light of the difficulty in obtaining written confidentiality agreements as part of the offering process.

I. Overview of the High-Yield Debt Market

High-yield securities are a critical method of raising capital for businesses that do not possess an investment grade rating from a rating agency and might not otherwise be able to access the bond markets.[2] Typically, a company will fail to win an investment-grade rating because of the firm's high level of debt, or financial leverage, or because of uncertainty regarding the company's future revenue. The market for high-yield securities in the United States has tripled over the last ten years, increasing from $200 billion in principal amount of securities outstanding in 1990 to approximately $600 billion in 2000.[3] Companies have issued over 5,000 high-yield bonds in the last ten years. This growth reflects the significant capital needs of high-yield issuers, as well as growing investor demand for the securities.[4]

High-yield securities share several characteristics that distinguish them from both equities and investment grade bonds and raise particular issues of concern under Regulation FD. First, high-yield securities are more sensitive to real or perceived changes in a firm's capacity to service its obligations. Companies that raise money with high-yield bonds often have high levels of financial leverage. They are, therefore, more vulnerable to increases in interest rates or a deterioration in the economic environment in their respective markets. Either could affect their ability to repay principal and interest.

Research analysts suggest these credit concerns have contributed to the decline in the volume of new issues of high-yield bonds over the last two years. The volume of new issues of high-yield securities amounted to $47.5 billion in the year 2000, compared to

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[2] For purposes of this statement, a high-yield security is one that is rated by at least one nationally recognized statistical rating organization and that does not possess at least one investment grade rating (*i.e.*, a rating of BBB-/Baa3 or higher).

[3] The Bond Market Association estimate.

[4] According to the Investment Company Institute, the net assets of high-yield bond mutual funds increased from $45.1 billion in 1994 to $116.9 billion in 1999.

$143.9 billion in 1998.[5] Sensitivity to such external factors underscores the importance of maintaining an adequate and consistent stream of high quality information about issuers in the high-yield sector. It is essential to the vitality of the high-yield market that analysts have access to the information necessary to identify credit issues on a timely basis and place their significance in the proper context.[6]

Second, companies that use high-yield securities are generally smaller, in financial terms, than companies in the investment grade bond market. These companies often have considerable competing demands on available financial resources and may not have adequate resources to communicate with the public on a regular basis. The quality and quantity of information companies provide is consequently limited by their ability to make the legal and business determinations and stage the broad, public dissemination of information required by Regulation FD.

Third, secondary market liquidity for high-yield bonds—liquidity refers to the ability to trade a security without substantially affecting its price—is not maintained as readily as in the market for investment grade securities. A lack of current information in the market, therefore, is more likely to have an effect on the pricing of high-yield bonds. In addition, many businesses that issue high-yield bonds are relatively small and not monitored by a broad group of analysts. As a result, the amount of information produced by analysts covering issuers of high-yield bonds has fewer points of origin and may be less extensive than is the case for companies that issue investment-grade bonds.[7]

II. Initial Experience with Regulation FD

A. Regulation FD Inhibits Disclosure in the High-Yield Marketplace

Based on our members' experience to date, Regulation FD has had an adverse impact on the volume and quality of information issuers provide to the public. The Regulation has improved access to material information in some respects, but it has also imposed constraints on communication between issuers and analysts. The Regulation limits the venues in which discussions tend to occur and narrows the range of information made available to the public – *e.g.*, issues of concern to the high-yield debt market. To avoid the cost of making the difficult materiality assessments required by Regulation FD, a number of companies have reduced the amount of information they provide and the frequency with which they disseminate information. This is particularly true for smaller firms that maintain a less extensive investor relations staff. The ability of high-yield bond analysts to collect information and disseminate it has been impaired as a result.

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5 The Bond Market Association Research Quarterly, Feb. 2001, page 5.

6 Unlike bond rating agencies, which evaluate solely the ability of an issuer to meet its obligations when and as they become due, high-yield analysts additionally provide "relative value" analysis of high-yield issues – *i.e.*, using established relationships based on criteria such as maturity, seniority, and industry prospects to identify situations in which certain issues may offer a better yield to investors vis-à-vis similarly situated issues.

7 This factor may be exacerbated in the case of high-yield issuers that have not issued publicly traded equity and are therefore followed only by fixed income analysts.

Companies and Analysts
The adoption of Regulation FD has markedly altered the quality of information available to analysts by limiting opportunities for in-depth dialogue with issuers—particularly on matters that are relevant to the high-yield market.

Many companies try to limit materiality assessments under Regulation FD—as well as to avoid the appearance of providing selective disclosure to analysts—by conducting the vast majority of communications with analysts and investors in public venues such as websites, teleconferences, or through regulatory filings. These formats have improved investor and market professional access to material information from companies. For example, since the implementation of Regulation FD, the amount of statistical and other relevant information provided by companies on their websites has improved significantly. In this way, Regulation FD has leveled the playing field for high-yield analysts and other market professionals who were previously excluded from conference calls with a company's favored equity analysts.

The Association favors the use of public venues and innovative technologies to communicate with investors and other market participants, but these venues suffer from numerous limitations and therefore cannot serve as an effective substitute for ongoing dialogue between companies and analysts. Publicly conducted webcasts and conference calls do not afford the same opportunities to acquire information essential to effective analysis of fixed income instruments. Large public settings render it more difficult to draw out the depth and nuance that can be elicited by the third, fourth or fifth follow-up question—questions that can only be asked in the one-on-one context. Moreover, issuers may find it easier in a public meeting to avoid insightful questions or to resist elaborating on specific issues—particularly where the questions do not relate directly to financial forecasts. The situation is analogous to the difference between a press conference and a one-on-one interview. A one-on-one interview is more likely to elicit detailed information while individuals can often deflect unfavorable questions in press conference settings.

Regulation FD has created particular problems for analysts that focus on issues of relevance to a specific market segment—such as high-yield bonds. Analysts in the high-yield market focus on issues that generally are not of interest to shareholders and equity analysts, such as covenant packages and related features of specific securities or financing. Because Regulation FD has channeled most disclosure into the above-mentioned venues, high-yield bond analysts must now compete with equity analysts and others for the limited time allotted for company conference calls and webcasts. In this context, high-yield and other bond analysts generally have had less opportunity to explore issues of concern to bondholders in detail. Likewise, asking multiple follow-up questions and probing assertions made by management on issues uniquely important to the bond market has also been difficult.

To overcome these obstacles to company-to-analyst communication under Regulation FD, the SEC should provide guidance on what information would be considered material under Regulation FD. Guidance of this nature would counteract the conservative reflex among certain firms and legal counsel to adopt silence as a way of steering clear of

problems under Regulation FD. In addition, this guidance could provide companies with a level of assurance concerning the basis on which the SEC's Enforcement Division would or would not pursue enforcement proceedings under Regulation FD.

Investors and Analysts
Regulation FD has reduced the frequency of companies' communication with investors and analysts and the amount of information made available when disclosures are made. The impact has varied from firm to firm and reflects a range of factors.

Smaller firms—with fewer resources and less extensive investor relations and legal staffs—have experienced greater difficulty in arranging for frequent discussions with analysts under Regulation FD. All companies, in considering whether to release information, must balance the benefits of disclosure against the legal expense associated with difficult materiality decisions. Other factors include the cost of making disclosure in a public setting or filing and the demand for scarce management time. In the case of smaller companies, this assessment has lead to less frequent and extensive disclosure.

The incentives for disclosure of information important to holders of high-yield bonds often will not outweigh the additional compliance burdens resulting from Regulation FD. Company management, whose principal fiduciary duty is to shareholders, has a greater interest in ensuring marketplace disclosure on issues affecting an issuer's equity securities than on those affecting solely its debt securities. Companies are less likely to create opportunities to permit high-yield analysts to obtain the specialized information they seek. In some situations, companies may have selectively invoked Regulation FD itself as a shield to avoid discussions with high-yield analysts. This problem is particularly acute, moreover, in cases where a company's only publicly traded securities are debt and not equity. In that case, high-yield analysts cannot benefit from information that might otherwise be provided for the equity security holders.

Regulation FD has a disproportionate impact on smaller firms that do not have the resources to make the assessments required by Regulation FD. The Association, therefore, recommends the SEC create an exemption from the rule for smaller firms.[8] In addition, we recommend a separate exemption for companies with public debt outstanding but no public equity. This would permit disclosures to be made to fixed income analysts in a context where the potential does not exist for the abuses against which Regulation FD is directed.

B. High-Yield Volatility has Increased and Liquidity has Decreased
Although a definitive assessment cannot yet be offered, our experience to date suggests the changes in the flow of information resulting from Regulation FD may have had a negative effect on the price volatility of high-yield bonds, as well as on the liquidity of smaller issues of high-yield bonds. In the Association's view, it is essential for the SEC to carefully assess the potential for longer-term, adverse effects on the efficiency of the high-yield bond market.

[8] "Smaller firms" could be defined as companies with a capitalization under a threshold amount.

Increased price volatility is particularly problematic in the high-yield market, which does not enjoy the depth of liquidity of the government or even the investment-grade corporate securities markets. In the case of less liquid securities (particularly those issued by smaller firms), the lack of access to regular information can decrease investor interest in trading between periodic disclosures. This reduces liquidity further, which, in turn, heightens the risk of greater volatility. While empirical data have not yet emerged, these risks could result in wider spreads or a reduction in the number of market makers for the bonds of a particular company. The cost of raising capital through high-yield bonds would increase as a result.

C. Regulation FD Places Added Burdens on the Private Placement Process

Regulation FD has increased the burdens on firms conducting Rule 144A private placements, particularly for small-cap companies. The regulation has heightened the importance to companies of avoiding disclosure of nonpublic information in the context of a private placement that might, in hindsight, be regarded as material. Because issuers have generally found it difficult to obtain confidentiality agreements from prospective investors, companies have deemed it necessary to adopt more stringent procedures for "sanitizing" private placement memoranda to ensure prospective purchasers receive no material information that is not simultaneously disclosed to the public.[9]

These additional procedures are costly and have introduced considerable delays in the private placement process without appreciably improving the information made available to the public.[10] For example, counsel must review private offering documents and assess the materiality of the disclosures, while question-and-answer sessions and other meetings with prospective investors must be carefully structured to avoid inadvertent disclosure of material information that will not have been simultaneously published.[11] Companies and their counsel must also make certain that all public disclosures (*e.g.*, on Form 8-K) are drafted in a manner that does not violate the prohibition against general solicitations under Section 5 of the Securities Act of 1933.[12] These additional steps, moreover, address a policy issue of only marginal concern, since issuers refrained from disclosing material, nonpublic information to investors in the context of private placements before Regulation FD was adopted.

To address this concern, we recommend the SEC create an exemption under Regulation FD for information conveyed by issuers in the course of completing an offering of

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[9] Prospective purchasers, typically large institutions, have almost uniformly been unwilling to agree to any confidentiality undertakings that might restrict their right to trade securities. This has proven especially true in the context of Rule 144A offerings, which play a central role in the high-yield securities markets, because of purchasers' desire to preserve complete flexibility to engage in resales.

[10] The Association understands that similar problems have been experienced in other fixed income market sectors, including mortgage-backed and asset-backed securities offerings conducted pursuant to Rule 144A.

[11] Material information that may be disseminated during roadshows for many registered offerings, by contrast, is not covered by Regulation FD. *See* Rule 100(b)(2)(iv) of Regulation FD.

[12] In the Regulation FD adopting release, the SEC acknowledged that Regulation FD requires public disclosure of material information provided to an investor in an unregistered offering "even if, as a result of such disclosure, the availability of the Securities Act registration exemption may be in question." Securities Act Release No. 7881 (Aug. 15, 2000), 65 Fed. Reg. 51,716, 51,725 (Aug. 24, 2000).

securities under the private placement/Rule 144A provisions of the federal securities laws. Regulation FD currently contains an exemption for disclosures made in the course of a registered offering under the Securities Act of 1933. We believe a parallel exemption for disclosures made during a Rule 144Aoffering or other private placement transaction should similarly be established under Regulation FD. Offerees in Rule 144A/private placement transactions would benefit from the opportunity to engage in the more flexible give-and-take that is permitted to occur in the context of road shows in public transactions. Moreover, there has been no suggestion that issuers or placement agents have used these transactions as a means of providing inappropriate selective disclosure or otherwise to engage in the abuses against which Regulation FD is directed.

Conclusion

Regulation FD was designed to encourage issuers to make full and fair disclosure of material information, but it appears the rule may have caused a decrease in the volume and quality of information that companies make available to the public. In particular, analysts have encountered significant difficulties in eliciting information—especially regarding issues of concern to the high-yield debt market—from companies that have come to rely on the use of public venues for the dissemination of material information to avoid making the materiality assessments required by Regulation FD.

In light of these developments, it is essential the SEC continue to assess the progress of companies and the analyst community in implementing Regulation FD and vigilantly monitor the impact of the regulation on the market for high-yield and other fixed income securities.

In particular, we recommend that the SEC consider approaches to alleviating the legal and administrative burdens of complying with Regulation FD as follows:

- Providing guidance on the difficult materiality assessments firms must make when engaging in discussions with analysts or other market professionals—particularly with respect to issues that concern only a limited segment of the market;

- Create an exemption from Regulation FD for firms below a certain capitalization threshold or that have outstanding high-yield debt but no publicly held equity; and

- Create an exemption for Regulation FD for disclosures made in connection with Rule 144A private placements.

We appreciate the Subcommittee's initiative in seeking views on Regulation FD from the bond underwriter and dealer community along with companies and investors. The Association's members look forward to working with the Subcommittee and the SEC to find ways to continue to ensure fair disclosure to all investors while improving the quality and efficiency of the fixed income markets.