

Regulation FD's Effect on Fixed-Income Investors: Is the Public Protected or Harmed?

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The [Securities and Exchange] Commission meets today to consider the adoption of rules designed to promote the full and fair disclosure of financial information. High quality and timely information is the lifeblood of strong, vibrant markets.

But when that information travels only to a privileged few, when that information is used to profit at the expense of the investing public, when that information comes by way of favored *access* rather than by acumen, insight, or diligence, we must ask, "Whose interest is *really* being served?"¹

INTRODUCTION

On August 10, 2000, following Chairman Arthur Levitt's impassioned opening statement,² the Securities and Exchange Commission ("SEC") adopted Regulation FD ("Fair Disclosure").³ The SEC enacted the regulation in an effort to eliminate the practice of selective disclosure, whereby corporate officials provide material, nonpublic information to Wall Street analysts before releasing the information to the general investing public.⁴ Under such practices, the SEC reasoned, analysts are "able to make a profit or avoid a loss *at the expense of those kept in the dark.*"⁵

Many authors will comment on Regulation FD's impact on institutional and individual stock market investors. Indeed, the predominant focus of the regulation was to level the playing field for equity investors of all sizes.⁶ However, regardless

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1. Securities and Exchange Commission Chairman Arthur Levitt, Opening Statement at the Securities and Exchange Commission's Meeting to Consider the Adoption of Regulation Fair Disclosure, at <http://www.sec.gov/news/extra/seldisal.htm> (Aug. 10, 2000) (emphasis in original) [hereinafter Levitt Statement].

2. *See id.*

3. Regulation FD, 17 C.F.R. §§ 243.100-.103 (2001). Regulation FD became effective October 23, 2000. Selective Disclosure and Insider Trading, Release Nos. 33-7881, 34-43154, IC-24599, 65 Fed. Reg. 51,716, 51,716 (Aug. 24, 2000) [hereinafter Final Rule Release].

4. Final Rule Release, *supra* note 3, at 51,716.

5. *Id.* (emphasis added).

6. *See infra* text accompanying notes 171-79. For the purposes of this Note, an "equity investment" refers to an investment in common stock. Common stock, the most widely held equity instrument, represents an ownership stake in a business entity. *See* FRANK K. REILLY & KEITH C. BROWN, INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT 82 (5th ed. 1997).

of the seemingly narrow intent of the SEC, the regulation has broad implications for investors in nonequity instruments. This Note addresses the impact of Regulation FD on the often overlooked fixed-income markets and their investors and beneficiaries.⁷ To provide a background for this analysis, Part I explores the motivation for Regulation FD, and Part II summarizes the regulation and its application to fixed-income issuers and analysts. Part III addresses the potential impact of Regulation FD on fixed-income analysts and direct and indirect beneficiaries of fixed-income security investments. This Note concludes that, contrary to its intended purpose, Regulation FD may harm both institutions *and the public* by impairing the ability of institutions to use fixed-income investments as a low-risk tool for generating predictable streams of income to fund insurance policies, endowments, charitable trusts, pension funds, and similar institutional products.

I. THE IMPETUS FOR REGULATION FD

Two factors compelled the SEC to propose Regulation FD. First, the SEC had become increasingly frustrated with the insider trading doctrine's ineffectiveness at battling selective disclosure.⁸ Second, the SEC felt increasing pressure to target selective disclosure because of the media's increasing scrutiny of alleged instances of selective disclosure.⁹ To understand the first catalyst for Regulation FD, it is necessary to summarize the gymnastics performed by the courts and the SEC in crafting the insider trading doctrine. Following this analysis, the second catalyst, the pressure of recent media attention, is briefly discussed.

7. Fixed-income investments are those securities that "have a contractually mandated payment schedule." REILLY & BROWN, *supra* note 6, at 78. Except for preferred stock, purchasers of "fixed-income securities . . . are really lenders to the issuers. Specifically, you lend some amount of money, the *principal*, to the borrower. In return, the borrower promises to make periodic interest payments and to pay back the principal at the maturity of the loan." *Id.* (emphasis in original). As its broad definition suggests, the term "fixed-income securities" encompasses a vast class of assets that includes savings accounts; certificates of deposit; U.S. Treasury bills, notes, or bonds; U.S. government agency securities; municipal bonds; mortgage bonds; and preferred stock. *Id.* at 78-80.

For the purposes of this Note, "fixed-income" refers to a subclass of those fixed-income securities that may be bought or sold by institutions and individuals in the secondary market, sometimes called capital market instruments. *Id.* at 78. Specifically, unless otherwise indicated, the Note will refer generally to corporate bonds and may interchange "fixed-income" and "bond." This Note's discussion of issuer disclosure practices refers to corporate bonds because, as a practical matter, the concept of ongoing issuer disclosure does not exist for instruments such as savings accounts, government securities, and certificates of deposit.

8. See Selective Disclosure and Insider Trading, Release Nos. 33-7787, 34-42259, IC-24209, 64 Fed. Reg. 72,590, 72,593-94 (Dec. 28, 1999) [hereinafter Proposed Rule Release].

9. See *id.* at 72,592-93.

*A. The Development of the Insider Trading Doctrine¹⁰ and
Its Perceived Ineffectiveness in Battling Selective Disclosure*

Historically, the SEC has attacked selective disclosure through the insider trading doctrine.¹¹ Although courts have identified insider trading abuses as “[o]ne of the primary purposes” of the Securities Exchange Act of 1934 (“Exchange Act”),¹² insider trading was not expressly prohibited under the securities laws¹³ prior to Regulation FD.¹⁴ Rather, the insider trading doctrine is a result of significant judicial gloss on the general prohibitions against manipulative and deceptive conduct under section 10(b) of the Exchange Act¹⁵ and Rule 10b-5¹⁶ promulgated thereunder.¹⁷

10. This discussion is not intended to summarize fully the development of the insider trading doctrine. Rather, several key developments, especially those identified by the SEC in Regulation FD’s rule proposal, are discussed.

11. Paul P. Brontas Jr., Note, *Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts*, 92 COLUM. L. REV. 1517, 1528 (1992) (citing Bruce A. Hiler, *The SEC and the Insider/Tipper*, N.Y. L.J., Aug. 29, 1991, at 5).

12. Richard M. Phillips & Robert J. Zutz, *The Insider Trading Doctrine: A Need For Legislative Repair*, 13 HOFSTRA L. REV. 65, 71 (1984) (quoting *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951)).

13. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 836 (3d ed. 1996).

14. In the same rule release as Regulation FD, the SEC adopted Rules 10b5-1 and 10b5-2. 17 C.F.R. § 240.10b5-1 to -2 (2001); see also Final Rule Release, *supra* note 3, at 51,716. In Rule 10b5-1(a), the SEC codifies the “misappropriation theory” of the insider trading doctrine as articulated by the Supreme Court in *United States v. O’Hagan*, 521 U.S. 642 (1997). 17 C.F.R. § 240.10b5-1(a); see also Proposed Rule Release, *supra* note 8, at 72,599-600. Under the misappropriation theory, a person violates the insider trading doctrine if he misappropriates “material nonpublic information for securities trading purposes, in breach of a duty of loyalty and confidence.” Proposed Rule Release, *supra* note 8, at 72,602. While not modifying the general insider trading doctrine, the SEC has clarified the extent of the requisite causation “between the trader’s possession of inside information and his or her trading.” *Id.* at 72,600. Specifically, subject to several enumerated affirmative defenses, “[a] trade is on the basis of material nonpublic information if the trader was aware of the material, nonpublic information when the person made the purchase or sale.” Final Rule Release, *supra* note 3, at 51,727; see also 17 C.F.R. § 240.10b5-1(b). Rule 10b5-2 provides a “non-exclusive list of three situations in which a person has a duty of trust or confidence for purposes of the ‘misappropriation’ theory.” Final Rule Release, *supra* note 3, at 51,730; see also 17 C.F.R. § 240.10b5-2(b). As is relevant to this Note, there is a “duty of trust or confidence” if “a person agrees to maintain information in confidence” or if the parties to a certain disclosure “have a history, pattern, or practice of sharing confidences,” under which there is an expectation of confidentiality. 17 C.F.R. § 240.10b5-2(b)(1)-(2).

However, as this Note focuses on Regulation FD, these Rules are not further discussed. Additionally, as evidenced by the SEC’s passage of Regulation FD, these rules do not remedy any perceived ineffectiveness of the insider trading doctrine in targeting selective disclosure.

15. 15 U.S.C. § 78j(b) (1994).

16. 17 C.F.R. § 240.10b-5 (2000). This rule provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means

Specifically, liability has been premised on Rule 10b-5's prohibition of "false statements and omissions of material fact in connection with purchases or sales of securities."¹⁸ However, "the breadth of Section 10(b) and Rule 10b-5 and their ability to encompass insider trading are matched by their vagueness in defining what conduct is prohibited, a fact demonstrated in the judicial decisions that have shaped the insider trading doctrine."¹⁹

The seminal case in the development of the insider trading doctrine under Rule 10b-5 is *In re Cady, Roberts & Co.*²⁰ In that case, a corporate insider at Curtiss-Wright Corporation informed a stockbroker at Cady, Roberts & Company, a registered broker-dealer, that Curtiss-Wright was going to cut dividends.²¹ Prior to the public release of this information, the Cady, Roberts broker sold shares of Curtiss-Wright stock in order to avoid the common stock price drop that would result from the news of the dividend cut.²² The SEC determined that the broker's conduct "operated as a fraud or deceit upon the purchasers,"²³ a violation of Rule 10b-5(c) of the Exchange Act.²⁴ The SEC observed that "[o]fficers, directors, and

or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

17. See HAZEN, *supra* note 13, at 836-37; Phillips & Zutz, *supra* note 12, at 65.

18. HAZEN, *supra* note 13, at 837.

19. Phillips & Zutz, *supra* note 12, at 73.

20. 40 S.E.C. 907 (1961), cited in HAZEN, *supra* note 13, at 838; see also Harvey L. Pitt & Karl A. Groskaufmanis, *A Tale of Two Instruments: Insider Trading in Nonequity Securities*, 49 BUS. LAW. 187, 190 (Nov. 1993) (stating that, in *In re Cady, Roberts*, the SEC "formally articulated the insider trading ban").

21. *In re Cady, Roberts*, 40 S.E.C. at 909.

22. *Id.* at 909, 911-12. Additionally, the Cady, Roberts broker shorted 5000 shares of Curtiss-Wright. *Id.* at 909. An investor sells stock short if he believes that the stock is overpriced and is likely to fall. REILLY & BROWN, *supra* note 6, at 127. "A short sale is the sale of stock that you do not own with the intent of purchasing it back later at a lower price." *Id.* To sell a stock short, "you would borrow the stock from another investor through your broker . . . and subsequently replace it at (you hope) a price lower than the price at which you sold it."

Id.

23. *In re Cady, Roberts*, 40 S.E.C. at 913.

24. *Id.* at 911; see also 17 C.F.R. § 240.10b-5(c) (2001) (making it unlawful "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security").

The SEC also found that the broker's conduct violated section 17(a) of the Securities Act of 1933 ("Securities Act"). *In re Cady, Roberts*, 40 S.E.C. at 911. Section 17(a) has language

shareholders—and those who effectively stood in the same position—[are] subject to a ‘special obligation’²⁵ and should, therefore, disclose or abstain from trading when in possession of insider information.²⁶ The SEC reasoned that such an obligation exists because of the “relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone . . . [and] the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.”²⁷

In *SEC v. Texas Gulf Sulphur Co.*,²⁸ the United States Court of Appeals for the Second Circuit affirmed the *In re Cady, Roberts* mandate that a party must disclose or abstain from trading when in possession of material, nonpublic information.²⁹ In that case, corporate insiders of Texas Gulf Sulphur Company had purchased stock ahead of the public announcement of a valuable ore discovery.³⁰ The court held that this violated Rule 10b-5 because such information would have been a material “fact to a reasonable . . . investor in deciding whether he should buy, sell, or hold.”³¹ The court premised liability on the notion that “access to material information [should] be enjoyed equally,”³² a premise that some commentators have labeled the “parity of information” approach.³³ Of particular significance to the development of selective disclosure liability, *Texas Gulf Sulphur* provided the foundation for subsequent courts to hold that the inside party who provides the material information may also be subject to fraud liability under Rule 10b-5.³⁴

Specifically, six years after *Texas Gulf Sulphur*, the Second Circuit decided *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*³⁵ and extended insider trading liability to the tipping party.³⁶ The defendant, Merrill Lynch, was a prospective underwriter for a Douglas Aircraft Company offering of convertible subordinated debentures.³⁷ During the course of the underwriting, because of Merrill Lynch’s

very similar to Rule 10b-5. *Id.* at 910. However, among other differences, “Section 17(a) prohibits fraudulent or deceptive practices ‘in the offer or sale’ of any security, [while] Rule 10b-5 prohibits such activities ‘in connection with the purchase or sale’ of any security.” *Id.* at 911 n.11.

25. Pitt & Groskaufmanis, *supra* note 20, at 190.

26. *Id.* at 191.

27. *In re Cady, Roberts*, 40 S.E.C. at 912 (footnote omitted); *see also* Pitt & Groskaufmanis, *supra* note 20, at 190-91.

28. 401 F.2d 833 (2d Cir. 1968).

29. *See* Pitt & Groskaufmanis, *supra* note 20, at 191.

30. *See Texas Gulf Sulphur*, 401 F.2d at 839-42.

31. *Id.* at 849-50.

32. *Id.* at 849.

33. *See, e.g.*, Proposed Rule Release, *supra* note 8, at 72,593.

34. *See HAZEN*, *supra* note 13, at 839 (citing *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980) and *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974)).

35. 495 F.2d 228, 231 (2d Cir. 1974).

36. *See HAZEN*, *supra* note 13, at 839.

37. *Shapiro*, 495 F.2d at 231.

position as an underwriter, Douglas's management advised Merrill Lynch that Douglas's earnings were going to be sharply down and that the company was going to reduce its estimates of future earnings.³⁸ Prior to any public release, Merrill Lynch advised several of its institutional clients of the expected shortfall.³⁹ Consequently, in the course of four days prior to public release, Merrill Lynch's "tipped" clients sold 165,000 shares of Douglas common stock.⁴⁰ The court held that Merrill Lynch's conduct:

violated Section 10(b) and Rule 10b-5 . . . based chiefly on our decision in *SEC v. Texas Gulf Sulphur Co.* . . . where we stated that "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it[,] . . . must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."⁴¹

Thus, the court explicitly extended potential insider trading liability to tippers—those who selectively disclose.

However, in *Chiarella v. United States*,⁴² the United States Supreme Court started to shut the door on effective selective disclosure liability based on the insider trading doctrine.⁴³ In that case, Chiarella, a "markup man" for a New York financial printer, had worked with several corporate takeover bid announcements.⁴⁴ The documents that Chiarella handled omitted the names of the takeover targets; however, Chiarella was able to "deduce the names of the target companies before the final printing."⁴⁵ Without disclosing this information, Chiarella made \$30,000 by purchasing "stock in the target companies and [selling] the shares immediately after the takeover attempts were made public."⁴⁶

In contrast to the traditional *Texas Gulf Sulphur* "parity of information" approach,⁴⁷ the Court held that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."⁴⁸ Rather, a duty only arises from "legislative enactments or a fiduciary relationship."⁴⁹ The Court's holding was a recognition of the constraints imposed by premising insider trading liability on the

38. *Id.* at 232.

39. *Id.*

40. *Id.* These shares constituted half of all Douglas common stock traded over those four days. *Id.*

41. *Id.* at 236 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968)) (third alteration in original).

42. 445 U.S. 222 (1980).

43. See Proposed Rule Release, *supra* note 8, at 72,593.

44. *Chiarella*, 445 U.S. at 224.

45. *Id.*

46. *Id.*

47. See Brontas, *supra* note 11, at 1528.

48. *Chiarella*, 445 U.S. at 235.

49. Brontas, *supra* note 11, at 1529 (citing *Chiarella*, 445 U.S. at 232).

antifraud provisions of section 10(b).⁵⁰ Specifically, the Court explained that section 10(b) catches only fraud, and “[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a *duty* to speak.”⁵¹ In sum, the Court greatly reduced the reach of the section 10(b) insider trading doctrine by reading the “fraud” back into the section.

In 1983, in *Dirks v. SEC*,⁵² the United States Supreme Court took perhaps the greatest step in limiting the reach of section 10(b) insider trading liability.⁵³ In 1973, Raymond Dirks was an officer of a New York broker-dealer firm that specialized in analyzing insurance company securities and providing recommendations to its institutional clients.⁵⁴ On March 6 of that year, Ronald Secrist, a former officer of Equity Funding of America (“Equity Funding”), contacted Dirks and told Dirks that Equity Funding had fraudulently overstated its assets.⁵⁵ Secrist prompted Dirks to verify that the company had indeed acted improperly and, if so, to publicly disclose the fraud.⁵⁶

Accordingly, Dirks decided to investigate Secrist’s allegations and visited Equity Funding’s Los Angeles headquarters.⁵⁷ There, Dirks met with company officers and employees.⁵⁸ Although senior management denied the fraud charges, some employees corroborated Secrist’s claims.⁵⁹ During the investigation, neither Dirks nor his firm owned any Equity Funding stock, but during his inquiry, Dirks discussed his findings with a number of his firm’s clients and other investors.⁶⁰ Consequently, several holders of Equity Funding stock sold their positions.⁶¹ Indeed, five investment advisers sold more than sixteen million dollars of Equity Funding stock.⁶² As a result of this trading, during Dirks’s two-week investigation, Equity Funding stock dropped from twenty-six dollars to under fifteen dollars per share.⁶³

During his investigation, Dirks prompted the *Wall Street Journal* to write a story on the fraud, but the *Journal* declined for fear that the charges were incorrect and that the paper would be subject to libel charges.⁶⁴ However, after the massive drop in Equity Funding’s stock price, the New York Stock Exchange halted trading.⁶⁵ Subsequently, California insurance authorities discovered evidence of Equity

50. *See id.*

51. *Id.* (emphasis added).

52. 463 U.S. 646 (1983).

53. *See Brontas, supra* note 11, at 1528-29.

54. *Dirks*, 463 U.S. at 648.

55. *Id.* at 649.

56. *Id.*

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.* at 650.

64. *Id.* at 649-50.

65. *Id.* at 650.

Funding's fraudulent activities.⁶⁶ Thereafter, the SEC filed a complaint against Equity Funding and only then did the *Wall Street Journal* publish a story.⁶⁷

The SEC then investigated Dirks's role in exposing Equity Funding's fraud.⁶⁸ After an inquiry, the commission held that "Dirks had aided and abetted violations of § 17(a) of the Securities Act of 1933[,] . . . § 10(b) of the Securities Exchange Act of 1934[,] . . . and SEC Rule 10b-5 . . . by repeating the allegations of fraud to members of the investment community who later sold their Equity Funding stock."⁶⁹

In so concluding, the SEC attempted to clear the *Chiarella* duty hurdle⁷⁰ by premising its claim "on the theory that he had constructively breached a fiduciary duty."⁷¹ Essentially, "the SEC maintained that anyone receiving information from an insider stands in the insider's shoes and should be held to the same standards and be subject to the same duties as that insider."⁷² Thus, the SEC reasoned that Secrist's fiduciary duty was transferred to Dirks.⁷³

However, because of Dirks's role in uncovering Equity Funding's fraud, the SEC only censured him.⁷⁴ After an unsuccessful review by the Court of Appeals for the District of Columbia Circuit,⁷⁵ Dirks filed a writ of certiorari to the United States Supreme Court.⁷⁶ "In view of the importance to the SEC and to the securities industry,"⁷⁷ the Court granted certiorari.⁷⁸

The Supreme Court rejected the Court of Appeals's and the SEC's approach.⁷⁹ In contrast, the Court held that "[i]n determining whether a tippee is under an obligation to disclose or abstain, it . . . is necessary to determine whether the insider's 'tip' constituted a breach of the insider's fiduciary duty."⁸⁰ Moreover, a fiduciary duty is breached only when "the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach."⁸¹ Thus, because Dirks, the tippee, had no fiduciary duty to Equity Funding, Dirks could only be liable if Secrist had breached a fiduciary duty by disclosing the fraud information.⁸² The Court stated that neither Secrist nor any of the other "tipppers" at

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.* at 650-51 (footnotes omitted).

70. See *supra* text accompanying notes 48-49.

71. Dale E. Barnes, Jr. & Constance E. Bagley, *Great Expectations: Risk Management Through Risk Disclosure*, 1 STAN. J.L. BUS. & FIN. 155, 185 (1994).

72. *Id.*

73. *Id.*

74. *Dirks*, 463 U.S. at 651-52.

75. *Id.* at 652.

76. *Id.*

77. *Id.*

78. *Dirks v. SEC*, 459 U.S. 1014 (1982).

79. See *Dirks*, 463 U.S. at 652.

80. *Id.* at 661.

81. *Id.* at 662.

82. *Id.* at 665.

Equity Funding had received any personal or monetary gain as a result of their disclosure.⁸³ Therefore, the insiders did not breach their duty; consequently, there was no derivative breach by Dirks.⁸⁴

However, the SEC resisted the Supreme Court's holding in *Dirks* and sought to make "selective disclosure a great deal riskier for corporate insiders."⁸⁵ In *SEC v. Stevens*,⁸⁶ the SEC alleged that Phillip J. Stevens, the former CEO and Chairman of Ultrasystems Corporation, had violated section 10(b) and Rule 10b-5.⁸⁷ Specifically, the SEC alleged that Stevens had become aware of a material earnings shortfall and had selectively disclosed this information in an effort to "protect and enhance his reputation."⁸⁸ The complaint further alleged that two of the tipped analysts had passed on the information to their clients, who in turn sold their stock before the public release of the expected earnings shortfall.⁸⁹ Although the case was settled before litigation began,⁹⁰ the SEC effectively announced its position that the "personal benefit" test articulated in *Dirks* could be satisfied by mere reputational benefits—a benefit that could be plausibly alleged in most cases of selective disclosure.

Stevens has been a source of much controversy. There has been significant debate on whether the SEC was attempting to resist *Dirks* and make new law through the enforcement action in *Stevens*.⁹¹ Additionally, authors have argued over whether the "personal benefit" test under *Dirks* requires a pecuniary benefit or if it may be satisfied through the SEC's reputational benefit approach in *Stevens*.⁹² In sum, *Stevens* did little to clarify the future of selective disclosure regulation as a form of insider trading.

Even after *Stevens*, in its release proposing Regulation FD, the SEC acknowledged that *Dirks* has substantially impeded the SEC's effort to regulate selective disclosure through the insider trading doctrine.⁹³ Indeed, the Supreme Court's decision in *Dirks* has widely been considered to have "imposed a difficult—and some say unsurpassable—requirement in selective disclosure cases."⁹⁴ In its proposal release for Regulation FD, the SEC cites *Dirks* as a catalyst for the regulation.⁹⁵ The SEC recognized the evidentiary problems in satisfying the "personal benefit" breach test and conceded that "many have viewed *Dirks* as affording considerable protection to

83. *Id.* at 666-67.

84. *Id.* at 667.

85. Brontas, *supra* note 11, at 1530.

86. Litigation Release No. 12813, 48 S.E.C. Docket (CCH) 739 (S.D.N.Y. Mar. 19, 1991).

87. *Id.* at 739.

88. *Id.*

89. *Id.* at 739-40.

90. *Id.* at 739.

91. See John C. Coffee, Jr., *The SEC and the Securities Analyst*, N.Y. L.J., May 30, 1991, at 5; see also Bruce A. Hiler, *The SEC and the Insider/Tipper*, N.Y. L.J., Aug. 29, 1991, at 5.

92. See Coffee, *supra* note 91, at 5; see also Hiler, *supra* note 91, at 5.

93. See Proposed Rule Release, *supra* note 8, at 72,593.

94. Stephen A. Radin, *Selective Disclosure After the SEC's Regulation FD*, N.Y. L.J., Aug. 31, 2000, at 1; see also Brontas, *supra* note 11, at 1529.

95. See Proposed Rule Release, *supra* note 8, at 72,593.

insiders who make selective disclosures to analysts, and to the analysts (and their clients) who receive selectively disclosed information."⁹⁶ Thus, the limitations of the mangled case law that loosely and unpredictably supported selective disclosure liability under section 10(b) and Rule 10b-5 provided significant motivation for Regulation FD. However, the SEC enacted Regulation FD only after increased media coverage of alleged instances of selective disclosure.

B. The Media: The Final Nudge Towards Regulation FD

After the *Dirks* decision in 1983, the viability of selective disclosure liability as a form of insider trading was unclear.⁹⁷ However, the SEC did not propose and adopt Regulation FD until seventeen years had passed. The SEC acknowledged in its proposing release that recent media reports of selective disclosure were a factor in its decision to propose Regulation FD.⁹⁸

Indeed, the SEC conceded that at least one study has shown that the incidence of selective disclosure has *decreased* from 1995 to 1998.⁹⁹ However, the SEC's concern was that the media's increasing coverage of alleged selective disclosure would undermine the market's integrity and investor confidence in the fairness of the markets.¹⁰⁰ Additionally, the SEC stated that "while issuer selective disclosure is not a new practice, the impact of such selective disclosure appears to be much greater in today's more volatile, earnings-sensitive markets."¹⁰¹ The SEC expressed concerns that corporate managers would treat information as a commodity and delay public disclosure in an effort to gain favorable treatment by analysts.¹⁰² Moreover, the SEC was concerned that this occurrence would lead to increased conflicts of interest whereby an analyst would tend to speak favorably about a company so that he or she could remain in the selective disclosure pipeline.¹⁰³

II. SUMMARY OF REGULATION FD AND ITS APPLICATION TO FIXED-INCOME ISSUERS AND ANALYSTS

On December 20, 1999, the SEC proposed Regulation FD¹⁰⁴ in response to the

96. *Id.* (citing Brontas, *supra* note 11, at 1529).

97. See *supra* text accompanying notes 85-92.

98. Proposed Rule Release, *supra* note 8, at 72,592 (citing George Anders & Robert Berner, *Webvan to Delay IPO in Response to SEC Concerns*, WALL ST. J., Oct. 7, 1999, at C16; Susan Pulliam, *Abercrombie & Fitch Ignites Controversy Over Possible Leak of Sluggish Sales Data*, WALL ST. J., Oct. 14, 1999, at C1; Susan Pulliam & Gary McWilliams, *Compaq Is Criticized for How It Disclosed PC Troubles*, WALL ST. J., Mar. 2, 1999, at C1; Randall Smith, *Conference Calls to Big Investors Often Leave Little Guys Hung Up*, WALL ST. J., June 21, 1995, at C1).

99. *Id.* at 72,592 n.16.

100. *Id.* at 72,592.

101. *Id.* at 72,592 (footnote omitted).

102. *Id.*

103. *Id.* at 72,592-93.

104. *Id.* at 72,611.

“problem of issuers making selective disclosure of material nonpublic information to analysts, institutional investors, or others, but not to the public at large.”¹⁰⁵ After roughly six thousand comments,¹⁰⁶ on August 10, 2000, the SEC adopted revised Regulation FD.¹⁰⁷ There was relative consensus among comment letters in support of and in opposition to Regulation FD that the goal of the regulation was positive. However, there was strong debate over whether the regulation achieved this result without introducing crippling side effects.¹⁰⁸

Regulation FD is an entirely new approach to combating selective disclosure. Instead of attempting to work with seemingly adverse case law, the SEC has promulgated a regulation that is not based on the insider trading doctrine under section 10(b) of the Exchange Act. Regulation FD is a contemporaneous *disclosure* rule, premised on the theory that if a company chooses to disclose a material fact, it should provide that information to the general investing public.

Regulation FD is comprised of four components.¹⁰⁹ Rule 100 sets forth the basic rule, Rule 101 provides relevant definitions and Rule 102 explicitly separates Regulation FD from section 10(b) liability under Rule 10b-5.¹¹⁰ Additionally, Rule 103 provides that a failure to disclose in compliance with Rule 100 will not affect an entity’s Exchange Act reporting status.¹¹¹ The general framework of Regulation FD is as follows:

- (1) [whenever] 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 who may well 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).¹¹²

105. *Id.* at 72,591.

106. Final Rule Release, *supra* note 3, at 51,717.

107. Regulation FD, 17 C.F.R. §§ 243.100-103 (2001).

108. *See, e.g.*, Letter from Michael S. Caccese, Senior Vice President, General Counsel, and Secretary, The Association for Investment Management and Research, to Jonathan Katz, Secretary, U.S. Securities and Exchange Commission (Aug. 8, 2000), *available at* <http://www.sec.gov/rules/proposed/s73199/caccese1.htm> [hereinafter AIMR Letter]; Letter from Irshad Karim, Chair, Corporate Bond Legal Advisory Committee, The Bond Market Association, to Jonathan Katz, Secretary, U.S. Securities and Exchange Commission (Apr. 28, 2000), *available at* <http://www.sec.gov/rules/proposed/s73199/karim1.htm> [hereinafter BMA Letter]; Letter from Craig S. Tyle, General Counsel, The Investment Company Institute, to Jonathan Katz, Secretary, U.S. Securities and Exchange Commission (Apr. 27, 2000), *available at* http://www.ici.org/select_com.html [hereinafter ICI Letter].

109. 17 C.F.R. §§ 243.100-103.

110. *See id.* §§ 243.100-102.

111. *Id.* § 243.103.

112. Final Rule Release, *supra* note 3, at 51,717; *see also* 17 C.F.R. § 243.100(a).

The following Parts briefly expand on the scope of the parties and information subject to Regulation FD, the regulation's disclosure mandates, and the consequence of noncompliance.

A. Issuers and Enumerated Persons

Regulation FD only applies to disclosures by a qualifying "issuer" or "person acting on its behalf."¹¹³ Under Rule 101, most issuers of publicly traded securities are subject to Regulation FD.¹¹⁴ Specifically, issuers that have "securities registered under Section 12"¹¹⁵ or are "required to file reports under Section 15(d) of the Securities Exchange Act of 1934"¹¹⁶ are subject to the regulation.¹¹⁷ Further, closed-end investment companies are explicitly included, while other investment companies, foreign governments, and foreign private issuers are explicitly excepted.¹¹⁸ Rule 101 defines a "person acting on [the issuer's] behalf" as "(1) any senior official of the issuer or (2) any other officer, employee, or agent of an issuer who regularly communicates with [securities market professionals] or with the issuer's security holders."¹¹⁹ Additionally, under section 20(b) of the Exchange Act, any person to whom the rule applies may not avoid the disclosure requirements under Regulation FD by directing a noncovered person to make a disclosure.¹²⁰

Qualifying "issuers" or "persons acting on [their] behalf" are only subject to Regulation FD if they seek to disclose to "certain enumerated persons."¹²¹ There are four categories of enumerated persons. The first three describe certain 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."¹²² These categories include institutional investment managers and buy- and sell-side analysts.¹²³ In addition to disclosure to investment professionals, disclosure to "any holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that such person would purchase or sell securities on the basis of the information," is subject to Regulation FD.¹²⁴

113. See Final Rule Release, *supra* note 3, at 51,719; see also 17 C.F.R. § 243.100(a).

114. See Regulation FD, 17 C.F.R. § 243.101(a)-(b) (2001).

115. 17 C.F.R. § 243.101(b) (citing 15 U.S.C. § 781 (1994)).

116. *Id.* (citing 15 U.S.C. § 78(o)(d) (1994)).

117. See *id.*

118. Final Rule Release, *supra* note 3, at 51,724.

119. *Id.* at 51,720. Under section 243.101, "securities markets professionals" are those parties described in section 243.100(b)(1)(i)-(iii), including brokers, dealers, investment advisers, institutional investment managers and investment companies. "Senior official" means any director, executive officer . . . investment relations or public relations officer, or other person with similar functions." 17 C.F.R. § 243.101(f).

120. Final Rule Release, *supra* note 3, at 51,720.

121. *Id.* at 51,719; see also 17 C.F.R. § 243.100(a), (b)(1).

122. Final Rule Release, *supra* note 3, at 51,719; see also 17 C.F.R. § 243.100(a), (b)(1).

123. Final Rule Release, *supra* note 3, at 51,719.

124. *Id.* at 51,719-20.

The four categories of enumerated persons are limited by four exclusions that are set forth in Rule 100(b)(2).¹²⁵ Under that rule, disclosure to the following parties is not subject to the disclosure requirements under Regulation FD: (1) “a person who owes the issuer a duty of trust or confidence—i.e., a ‘temporary insider’—such as an attorney, investment banker, or accountant,”¹²⁶ (2) “any person who expressly agrees to maintain the information in confidence,”¹²⁷ (3) “an entity whose primary business is issuance of credit ratings, provided the information is [for that purpose] and the entity’s ratings are publicly available[.]”¹²⁸ and (4) “[entities] in connection with most offerings of securities registered under the Securities Act.”¹²⁹

In sum, Regulation FD potentially applies to disclosures by an issuer, or someone acting on its behalf, to an institutional fixed-income analyst. First, as Regulation FD applies to most issuers of publicly traded securities, domestic issuers of fixed-income securities are likely subject to the regulation’s disclosure requirements. Second, the definition of “any person acting on its behalf” applies to any “officer, employee, or agent of an issuer who regularly communicates with any [securities market professionals].”¹³⁰ Therefore, Regulation FD explicitly applies to communications by virtually any party of the issuer with an analyst. Indeed, some qualifying issuer communication with an institutional fixed-income analyst will be outside the scope of Regulation FD because it relates to a securities offering or there has been an express confidentiality agreement.¹³¹ However, absent these limited exceptions, both issuers and analysts of fixed-income securities are within the scope of Regulation FD and together trigger its disclosure scheme.

B. Material Nonpublic Information

A disclosure by a covered “issuer” to an “enumerated person” is only subject to Regulation FD if the issuer seeks to communicate “material nonpublic information regarding that issuer or its securities.”¹³² However, Regulation FD does not define “material” or “nonpublic.”¹³³ Rather, in its Final Rule Release, the SEC refers to existing case law definitions.¹³⁴ For the definition of “material,” the SEC primarily defers to the United States Supreme Court’s decision in *TSC Industries, Inc. v.*

125. 17 C.F.R. § 241.100(b)(2).

126. Final Rule Release, *supra* note 3, at 51,720; *see also* 17 C.F.R. § 243.100(b)(2).

127. Final Rule Release, *supra* note 3, at 51,720; *see also* 17 C.F.R. § 243.100(b)(2)(ii).

128. Final Rule Release, *supra* note 3, at 51,720; *see also* 17 C.F.R. § 243.100(b)(2)(iii).

129. Final Rule Release, *supra* note 3, at 51,720; *see also* 17 C.F.R. § 243.100(b)(2)(iv).

130. 17 C.F.R. § 243.101(c); *see also* § 243.100(b)(1)(i)-(iii); Final Rule Release, *supra* note 3, at 51,719-20.

131. 17 C.F.R. § 243.100(a), (b)(2)(ii), (b)(2)(iv). Although securities offerings remain a concrete exception, as will be discussed in Part III.A, confidentiality agreements do not appear to have been effective in maintaining pre-Regulation FD levels of nonmaterial issuer communication. Additionally, analysts may be unwilling to enter into confidentiality agreements for fear of insider liability. *See infra* text accompanying notes 235-38.

132. 17 C.F.R. § 243.100(a).

133. Final Rule Release, *supra* note 3, at 51,721.

134. *Id.*

*Northway, Inc.*¹³⁵ There, the Court held that “[i]nformation is material if ‘there is a substantial likelihood that a reasonable shareholder would consider it important’ in making an investment decision.”¹³⁶ The Court further held that “[t]here must be a substantial likelihood that a fact ‘would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.’”¹³⁷ As to the definition of “nonpublic,” the SEC referred to *SEC v. Texas Gulf Sulphur Co.*¹³⁸ and *In re Investors Management Co.*,¹³⁹ where “nonpublic” information was defined as material that “has not been disseminated in a manner making it available to investors generally.”¹⁴⁰

Although Regulation FD relies on case law definitions of material nonpublic information, in its Final Rule Release, the SEC enumerates several items that “should be reviewed carefully to determine whether they are material.”¹⁴¹

(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 (e.g., the acquisition or loss of a contract); (4) changes in control or in management; (5) changes 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—e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and (7) bankruptcies or receiverships.¹⁴²

Certain information that involves earnings guidance, for example, is clearly material and within the intended scope of Regulation FD. However, as is illustrated in Part III.A, what is potentially more problematic for fixed-income issuers and analysts is the information that is not clearly material or immaterial and the resulting disclosure practices of an issuer faced with this uncertainty.

135. 426 U.S. 438, 449 (1976).

136. Final Rule Release, *supra* note 3, at 51,721 (quoting *TSC Indus., Inc.*, 426 U.S. at 449). Additionally, the Final Rule Release refers to *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), and its holding that “materiality with respect to contingent or speculative events will depend on a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.” Final Rule Release, *supra* note 3, at 51,721 (citing *Basic, Inc.*, 485 U.S. at 231).

137. *Id.* (quoting *TSC Indus., Inc.*, 426 U.S. at 449).

138. 401 F.2d 833 (2d Cir. 1968).

139. 44 S.E.C. 633 (1971).

140. Final Rule Release, *supra* note 3, at 51,721 (citing *Texas Gulf Sulphur Co.*, 401 F.2d at 854; *In re Investors Mgmt. Co.*, 44 S.E.C. at 643).

141. *Id.* at 51,721. The SEC made clear, however, that this list is nonexhaustive and that the items that do appear are not “*per se* material.” *Id.*

142. *Id.*

C. Disclosure Requirements

If the issuer, the recipient, and the information sought to be disclosed are within the scope of the regulation, Regulation FD's disclosure rules apply. However, the timing of the required public disclosure hinges on whether a disclosure was intentional or nonintentional.¹⁴³ Rule 101(a) of the regulation provides that "a selective disclosure is 'intentional' when the issuer or person acting on behalf of the issuer making the disclosure either knows, or is reckless in not knowing, prior to making the disclosure, that the information he or she is communicating is both material and nonpublic."¹⁴⁴ In such case, under Rule 100(a)(1), an issuer must simultaneously disclose the same information to the public.¹⁴⁵

In contrast, under Rule 100(a)(2), when an issuer who makes a nonintentional selective disclosure that falls under the rule, the issuer must "promptly" disclose to the public.¹⁴⁶ Rule 101(d) provides that a disclosure is "prompt" if made:

as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange) after a senior official of the issuer . . . learns that there has been a non-intentional disclosure by the issuer or person acting on behalf of the issuer of information that the senior official knows, or is reckless in not knowing, is both material and nonpublic.¹⁴⁷

In the case of both intentional and nonintentional disclosures, Rule 101(e)¹⁴⁸ defines the requisite public disclosure. The only way to positively comply with Regulation FD's mandate is to file or furnish a Form 8-K.¹⁴⁹ To "file" a Form 8-K, an issuer merely provides a report under Item 5 of Form 8-K.¹⁵⁰ In such case, "the information will be subject to liability under Section 18 of the Exchange Act . . . [and] will be subject to automatic incorporation by reference into the issuer's Securities Act registration statements, which are subject to liability under Sections 11 and 12(a)(2) of the Securities Act."¹⁵¹ In contrast, an issuer may merely "furnish" the information by providing the information under Item 9 of Form 8-K.¹⁵² If Item 9 is used, under most circumstances, the material is not subject to potential liability under section 11 of the Securities Act or section 18 of the Exchange Act.¹⁵³

143. See Regulation FD, 17 C.F.R. § 243.100(a) (2001).

144. *Id.* § 243.101(a).

145. Final Rule Release, *supra* note 3, at 51,722; see also 17 C.F.R. § 243.100(a)(1).

146. Final Rule Release, *supra* note 3, at 51,722; see also 17 C.F.R. § 243.100(a)(2).

147. 17 C.F.R. § 243.101(d). "[I]n the case of a closed-end investment company, a senior official of the issuer's investment adviser" is the relevant senior official. *Id.*

148. *Id.* § 243.101(e).

149. See *id.*; see also 17 C.F.R. § 249.308; Final Rule Release, *supra* note 3, at 51,723-24.

150. See Final Rule Release, *supra* note 3, at 51,723; see also 17 C.F.R. § 249.308.

151. See Final Rule Release, *supra* note 3, at 51,723; see also 17 C.F.R. § 249.308.

152. Final Rule Release, *supra* note 3, at 51,723.

153. *Id.* Only when an issuer "takes steps to include that disclosure in a filed report, proxy statement, or registration statement" can such liability potentially follow. *Id.*

Regardless of whether filed or furnished, the disclosure "will not, by itself, be deemed an admission as to the materiality of the information."¹⁵⁴

If an issuer chooses not to provide the information through a Form 8-K, it may distribute the material in a manner that "is reasonably designed to provide broad, non-exclusionary distribution of the information to the public."¹⁵⁵ However, the Rule provides no further guidance. Instead, the Final Rule Release provides a number of examples of how this result may be achieved.¹⁵⁶ Generally acceptable practices "include press releases distributed through a widely circulated news or wire service, or announcements made through press conferences or conference calls that interested members of the public may attend or listen to either in person, by telephonic transmission, or by other electronic transmission (including use of the Internet)."¹⁵⁷ The SEC warns that adequate notice and means must be provided before conference calls and that mere posting of information on a website will likely not suffice.¹⁵⁸ Most importantly, the SEC warns that, although issuers are given "considerable flexibility in choosing appropriate methods of public disclosure, it also places a responsibility on the issuer to choose methods that are, *in fact*, 'reasonably designed' to effect a broad and non-exclusionary distribution of information to the public."¹⁵⁹ Therefore, an issuer that elects not to use a Form 8-K risks noncompliance for failing to choose a satisfactory disclosure medium.

D. Liability

In its Final Rule Release, the SEC made clear that Regulation FD is not an antifraud rule. Rather, it "is an issuer disclosure rule that is designed to create duties only under Sections 13(a) and 15(d) of the Exchange Act."¹⁶⁰ Unlike other reporting requirements under sections 13(a) or 15(d) of the Exchange Act,¹⁶¹ under Rule 102 of Regulation FD, "[a] failure to make a public disclosure required *solely* by [Regulation FD] shall not be deemed to be a violation of Rule 10b-5."¹⁶²

Instead of Rule 10b-5 liability, an issuer that violates Regulation FD is subject to an "SEC enforcement action alleging violations of Section 13(a) or 15(d) of the Exchange Act . . . and Regulation FD."¹⁶³ In its Final Rule Release, the SEC warns

154. *Id.*

155. 17 C.F.R. § 243.101(e)(2).

156. *See* Final Rule Release, *supra* note 3, at 51,723-24.

157. *Id.*

158. *See id.* at 51,724.

159. *Id.* (emphasis added).

160. *Id.* at 51,726. For a closed-end investment company, alleged violations are based on section 30 of the Investment Company Act. *Id.*

161. *Id.* at 51,726 n.86.

162. 17 C.F.R. § 243.102 (2001) (emphasis added); *see also* Final Rule Release, *supra* note 3, at 51,726. This provision was added to allay the concerns expressed in response to the Proposed Rule Release that an individual could bring a private action under Rule 10b-5 based on a violation of Regulation FD. *See* Final Rule Release, *supra* note 3, at 51,726.

163. Final Rule Release, *supra* note 3, at 51,726. An enforcement action against a closed-end investment company would be premised on section 30 of the Investment Company Act.

that it “could bring an administrative action seeking a cease-and-desist order, or a civil action seeking an injunction and/or civil money penalties.”¹⁶⁴ The SEC further warns that it could “bring an enforcement action against an individual at the issuer responsible for the violation, either as ‘a cause of’ the violation in a cease-and-desist proceeding, or as an aider and abetter of the violation in an injunctive action.”¹⁶⁵

Although noncompliance with Regulation FD *alone* does not lead to Rule 10b-5 liability, in its Final Rule Release, the SEC stresses the significance of its use of “solely” in Rule 102.¹⁶⁶ In sum, the SEC warns that the regulation does not “affect any existing grounds for liability under Rule 10b-5”:

[F]or example, liability for “tipping” and insider trading under Rule 10b-5 may still exist if a selective disclosure is made in circumstances that meet the *Dirks* “personal benefit” test. In addition, an issuer’s failure to make a public disclosure still may give rise to liability under a “duty to correct” or “duty to update” theory . . . [a]nd an issuer’s contacts with analysts may lead to liability under the “entanglement” or “adoption” theories. In addition, if an issuer’s report or public disclosure made under Regulation FD contained false or misleading information, or omitted material information, Rule 102 would not [bar] Rule 10b-5 liability.¹⁶⁷

Thus, although Regulation FD is a disclosure and not an antifraud rule, the SEC has made clear that the regulation in no way precludes traditional 10b-5 liability. Indeed, the SEC cites *SEC v. Stevens*¹⁶⁸ in Regulation FD’s Final Rule Release.¹⁶⁹ Therefore, the SEC continues to contend that the “personal benefit” test of *Dirks* may be satisfied by a “reputational gain,” a result that provides the SEC with the opportunity to persist in targeting selective disclosure as a violation of the insider trading doctrine.¹⁷⁰ Therefore, Regulation FD is simply *another* tool for the SEC to combat “improper” issuer information.

III. REGULATION FD’S IMPACT ON FIXED-INCOME INVESTORS

At the end of 1995, the market value of publicly issued bonds in the United States exceeded seven trillion dollars, two trillion dollars greater than the combined market

Id.

164. *Id.* (citations omitted).

165. *Id.* (citations omitted).

166. See Harold S. Bloomenthal, *Fair Disclosure—Regulation FD*, 22 Sec. & Fed. Corp. L. Rep. (West) at 70 (Sept. 2000).

167. Final Rule Release, *supra* note 3, at 51,726 (citations omitted).

168. Litigation Release No. 12,813, 48 S.E.C. Docket (CCH) 739 (S.D.N.Y. Mar. 19, 1991).

169. See *id.*; see also JOHN J. HUBER ET AL., LATHAM & WATKINS, THE SEC’S REGULATION FD—FAIR DISCLOSURE 78-79 (2000), available at <http://www.lw.com/pubs/articles/pdf/fd.pdf> [hereinafter LATHAM & WATKINS].

170. See LATHAM & WATKINS, *supra* note 169, at 78-79.

value of the stock market.¹⁷¹ However, in 1991, the SEC Commissioner observed that “[t]he fixed income markets . . . have largely been an ‘after-thought’ in our regulatory scheme.”¹⁷² It is unlikely that Regulation FD represents a shift in the SEC’s concern about securities abuses in the fixed-income markets; yet, perhaps with little consideration, it may have dramatic consequences for fixed-income investors.

The majority of the commentary on Regulation FD is likely to address the regulation’s impact on the highly publicized equity market; with only brief reflection, this seems to be the most relevant discussion. Regulation FD was enacted to target disclosure practices in the equity markets and to provide equal access to information for equity investors.¹⁷³ Indeed, every media report cited by the SEC in its proposing release involved alleged selective disclosure to equity analysts who subsequently traded in advance of public disclosure to either achieve gains or avoid losses.¹⁷⁴ Additionally, Regulation FD focuses on the protection of the individuals that comprise the investing public,¹⁷⁵ a group that seldom directly participates in the bond market. Because of the bond “market’s complexity and the high minimum denominations of most [bond] issues,”¹⁷⁶ individual investors account for only five to ten percent of bond trading.¹⁷⁷ Institutions trade the balance.¹⁷⁸ In contrast, individual ownership of stocks has never been more prevalent.¹⁷⁹

Although Regulation FD was targeted at disclosure practices in the equity markets

171. REILLY & BROWN, *supra* note 6, at 489. Globally, the market value of all publicly issued bonds was roughly \$18 trillion, while the market value of all stocks was approximately \$12.5 trillion. *Id.*

172. Richard Roberts, Additional Attention Warranted for Debt Markets, Remarks Before the National Federation of Municipal Analysts (Apr. 18, 1991), *quoted in* Harvey L. Pitt & Karl A. Groskaufmanis, *A Tale of Two Instruments: Insider Trading in Non-equity Securities*, 49 BUS. LAW. 187, 256 n.484 (Nov. 1993); *cf.* REILLY & BROWN, *supra* note 6, at 489 (discussing the importance of fixed-income markets).

173. Although as much is not explicitly stated in the Proposed or Final Rule Releases, it is evident from accompanying commentary that Regulation FD was enacted to combat perceived selective disclosure practices in the stock markets. In Chairman Arthur Levitt’s statement at the opening of the SEC’s meeting to consider Regulation FD, he made no reference to disclosure problems in the fixed-income markets. Levitt Statement, *supra* note 1. Rather, he stated that, “[i]f investors see a stock’s price change dramatically—but are given access to critical market-moving information only much later—we risk nothing less than the public’s faith and confidence in America’s capital markets.” *Id.* Further, Chairman Levitt stated, “Wall Street analysts play an increasingly visible role in recommending stocks, some in corporate management treat material as a commodity—a way to gain and maintain favor with particular analysts.” *Id.*

174. *See supra* note 98.

175. *See* Final Rule Release, *supra* note 3, at 51,716; *see also supra* note 1 and accompanying text.

176. REILLY & BROWN, *supra* note 6, at 497.

177. *See id.*

178. *See id.* Because of differing investment objectives and tax consequences, different institutions invest in various sectors of the bond market. *Id.*

179. *Id.* at 640.

and meant to level the playing field for individual equity investors, it is not limited to disclosure practices of equity issuers.¹⁸⁰ As will be shown in the following sections, the regulation has the potential to significantly impact the institutions that directly own the majority of bonds and those individuals who benefit as a result of such institutional ownership. Subpart A addresses this Note's contention that Regulation FD will reduce the amount of public disclosure of both material and immaterial issuer information, a result that directly conflicts with the regulation's purpose.¹⁸¹ Subpart B discusses why a reduction in such issuer communication, "chilling," has severe consequences for fixed-income investment analysts because of their unique information requirements. Subpart C discusses the contention that, even absent "chilling," Regulation FD compliant disclosure methods do not allow fixed-income analysts to obtain the information that they require. Subpart D contends that a reduction in issuer disclosure and the resulting inability of institutions to generate low-risk, predictable income streams harms institutional investors and individuals who indirectly benefit from institutional bond ownership. Finally, Subpart E discusses the dollar cost for issuers to distribute preregulation levels of information to fixed-income analysts while complying with Regulation FD.

A. The Impact of Regulation FD on Issuer Communication

Regulation FD was intended to assure that issuer disclosure of material information to analysts does not precede full disclosure of the same information to the investing public.¹⁸² However, instead of remedying the timing of disclosure, Regulation FD may simply reduce or eliminate corporate disclosure.¹⁸³ This contention, commonly referred to as "chilling," is premised on the reasoning that, when faced with the risk of uncertain liability under the regulation for improper disclosure, companies will simply not disclose at all.¹⁸⁴

Two components of Regulation FD have led to the concern that, because it is difficult to comply, or to determine compliance, with the regulation, issuers may stop or decrease the amount of disclosure. First, Regulation FD provides no clear definition of materiality.¹⁸⁵ Because an issuer may be unclear as to whether information is material and, therefore subject to Regulation FD, an issuer will choose not to disclose in order to avoid the risk of liability or the cost of compliance.¹⁸⁶ Second, beyond furnishing a costly Form 8-K, Regulation FD provides no clear definition of what constitutes adequate public disclosure.¹⁸⁷ Therefore, even if an

180. See Regulation FD, 17 C.F.R. § 243.101(b) (2001).

181. See Proposed Rule Release, *supra* note 8, at 72,591. In laying the background for proposing Regulation FD, the SEC stated that, "[f]ull and fair disclosure of information by issuers of securities to the investing public is a cornerstone of the federal securities laws." *Id.*

182. See Final Rule Release, *supra* note 3, at 51,716.

183. See, e.g., AIMR Letter, *supra* note 108; BMA Letter, *supra* note 108; ICI Letter, *supra* note 108.

184. See Final Rule Release, *supra* note 3, at 51,718.

185. See *supra* text accompanying notes 132-42.

186. See Final Rule Release, *supra* note 3, at 51,718.

187. See *supra* text accompanying notes 149-59.

issuer has determined that the information that he seeks to disclose is material, the issuer may choose not to disclose because it is unclear what alternate methods of disclosure will comply with the regulation. A survey performed shortly before Regulation FD was enacted supports this concern.¹⁸⁸ In that survey, 42% of respondents (462 investor relations professionals) indicated that corporations would limit communication practices and 12% indicated that they would “significantly” limit communication practices if Regulation FD was passed.¹⁸⁹

The SEC made several changes to the proposed rule in an effort to allay concerns that Regulation FD would reduce issuer communication.¹⁹⁰ In perhaps the most significant respect, the SEC has explicitly provided, through Rule 102, that noncompliance will not solely lead to Rule 10b-5 liability.¹⁹¹ In sum, Regulation FD does not *limit or expand* any existing liability arising out of Rule 10b-5,¹⁹² and noncompliance solely with Regulation FD leads only to an SEC enforcement action for violations of section 13(a) or 15(d) of the Exchange Act and Regulation FD.¹⁹³ However, although the SEC did slightly clarify the requirements for “public disclosure,” it did not further define “material” in its final rule.¹⁹⁴

The extent of the chilling effect of the final enacted Regulation FD remains to be seen. However, early indications provide support for this concern. For example, in a survey by Thomson Financial/Carson Global Consulting, performed shortly after Regulation FD was enacted, 33% of respondents (eighty-one companies distributed widely among markets and market capitalization) indicated that they have limited the information they have provided and 9% indicated that they no longer have one-on-one discussions with analysts.¹⁹⁵ Recent research has similarly indicated that Regulation

188. See Press Release, National Investor Relations Institute, NIRI Survey Finds Adoption of Regulation Full Disclosure Likely to Limit Amount of Information Disclosed to Market Participants (Aug. 2000), available at <http://www.niri.org/publications/alerts/EA080800.cfm>.

189. See *id.* The National Investor Relations Institute’s (“NIRI’s”) survey further indicated that 34.9% would reduce or eliminate individual meetings with institutional investors or analysts; 32.3% would reduce or eliminate participation in “broker-sponsored analyst meetings”; 27.7% would reduce or eliminate participation in “company sponsored group meetings”; 24.3% would reduce or eliminate plant tours; 22.5% would reduce or eliminate the “question and answer component of conference calls”; and 10.2% would reduce or eliminate conference calls. *Id.*

190. Final Rule Release, *supra* note 3, at 51, 718-19.

191. Regulation FD, 17 C.F.R. § 243.102 (2001).

192. The SEC has left itself with broad room to attack selective disclosure as a form of insider trading. Specifically, the SEC continues to contend that the *Dirks* “personal benefit test” may be satisfied by mere “reputational benefits.” See *supra* notes 168-70 and accompanying text.

193. See 17 C.F.R. § 243.102 (2001). In the case of a closed-end investment company, the enforcement action would be premised on section 30 of the Investment Company Act. See *id.*

194. See Final Rule Release, *supra* note 3, at 51,721, 51,723-24.

195. Neal Lipschutz, *Disclosure Rule's Early Mixed Report Card*, Dow Jones News Service (Jan. 19, 2001), at <http://www.ccbn.com/regulationfd/20010119.html> (citing study by Thomson Financial/Carson Global Consulting).

FD has led to a reduction in the quality of issuer communication. In a survey performed by the Association for Investment Management and Research, “57% of portfolio managers and analysts indicated that the volume of substantive information released by the public companies they research has decreased since [Regulation FD] took effect.”¹⁹⁶ The survey further indicated that 56% of respondents found that the quality of information had also decreased and 81% of respondents agreed that, after the regulation was enacted, “companies that want to minimize communication with investors can do so more effectively.”¹⁹⁷ Additionally, 71% of respondents indicated that Regulation FD has contributed to market volatility, with many reasoning that this is “due to lessening of earnings guidance and consequently more earnings surprises.”¹⁹⁸

Prompted by concerns that Regulation FD has impaired the flow of quality information to investors, on May 17, 2001, the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises held a hearing.¹⁹⁹ In that hearing, several witnesses stated that Regulation FD has reduced the quality of issuer information. The Senior Vice President and General Counsel of the Securities Industry Association (“SIA”) reported that, in a recent SIA survey, 76% of analysts who responded found 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.”²⁰⁰ Additionally, the General Counsel of Nomura Corporate Research and Asset Management, Inc., similarly stated that “less information is provided, and in a less timely manner.”²⁰¹ Further, he stated that his firm has found that many corporate issuers had either stopped or had decreased the practice of providing nonmaterial “‘building block’ components of revenue, expense and margin data.”²⁰² In a written statement addressing the effect of Regulation FD on the high-

196. Press Release, Association for Investment Management and Research, Analysts, Portfolio Managers Say Volume, Quality of Information Have Fallen Under Regulation FD (March 26, 2001), available at http://www.aimr.org/pressroom/01releases/regFD_survey.html (summary of survey available at http://www.aimr.org/pressroom/01releases/regFD_surveysum.htm).

197. *Id.*

198. *Id.* But see Press Release, PriceWaterhouseCoopers, Leaders of Technology Businesses See Benefits From Regulation FD (Apr. 23, 2001), available at <http://www.barometersurveys.com/pr/te010423.html> (finding that “a greater number of technology companies is [sic] disclosing more, rather than less information—and tending to do so sooner”).

199. See “Fair Disclosure or Flawed Disclosure: Is Reg. FD Helping or Hurting Investors?”: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the House Comm. on Financial Services, 107th Cong. 107-18 (2001), available at <http://www.house.gov/financialservices/051701wl.htm> [hereinafter *Regulation FD Hearing*].

200. *Id.* (testimony of Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association).

201. *Id.* (testimony of Patrick D. Sweeney, General Counsel, Nomura Corporate Research and Asset Management, Inc.).

202. *Id.*

yield bond marketplace, The Bond Market Association also indicated that the quality and volume of information has decreased.²⁰³ The Bond Market Association further contended that a company's fiduciary duty to its shareholders creates an incentive for the company to focus on disclosing information relating its equity securities rather than that information solely relating to its debt issues.²⁰⁴

Even with recent indications that the regulation has reduced the quantity and quality of issuer disclosure, it is difficult to predict the extent to which chilling will occur after corporations get past the initial shock of the regulation. Perhaps the market will experience a high degree of chilling while the definitions of "material" and "adequate public disclosure" are further fleshed out and while companies wait to see how aggressively the SEC will pursue marginal Regulation FD violations.²⁰⁵ However, it is likely that there will be some decrease in issuer communication to avoid the risk of liability and, at a minimum, the costs of compliance.²⁰⁶ Because of the extensive information requirements of fixed-income analysts, even a slight decrease in issuer communication may severely impede the ability of investors to prudently assess the risk and overall suitability of fixed-income instruments.

203. *Id.* (written statement submitted by The Bond Market Association).

204. *Id.* (written statement submitted by The Bond Market Association).

205. The Director of the SEC's Division of Enforcement has stated that Regulation FD will not be treated as a "trap for the unwary" and that the SEC is "not going to second-guess close calls regarding the materiality of a potential disclosure." Richard H. Walker, Regulation FD—An Enforcement Perspective, Remarks to the Compliance and Legal Division of the Securities Industry Association (Nov. 1, 2000), *available at* <http://www.sec.gov/news/speech/spch415.htm>. Indeed, the Director has gone so far as to blame any "chilling effect" on "an overabundance of caution, fed by the dire predictions of numerous law firms and others opposed to the rule." *Id.*

206. *See infra* Part III.E for a discussion of the costs of complying with Regulation FD.

B. Information Requirements of Fixed-Income Analysts²⁰⁷

Because of the nature and variety of fixed-income securities, fixed-income analysts often require different types of information than do equity analysts.²⁰⁸ Equity portfolios are generally comprised of a single equity instrument—voting shares of common stock.²⁰⁹ Actively managed, analyst-intensive, equity portfolios are constructed by accumulating a portfolio of stocks based on an analyst's evaluation of the economy, industries, and a company's "strategies and competitive advantages."²¹⁰ A fixed-income portfolio manager similarly structures a portfolio with a diversification of issuers and industries. However, in addition, a fixed-income portfolio manager may choose from a seemingly infinite number of fixed-income instruments. For example, a fixed-income portfolio manager can choose from U.S. Treasury bills, notes, or bonds; corporate bonds; mortgage-backed securities; and asset-backed securities.²¹¹

207. This Note discusses fixed-income investment analysis and portfolio management at a very general level. There are many types of portfolio management strategies that result in various degrees of fixed-income investment analysis.

At one end of the spectrum, in "pure bond index matching," a portfolio manager attempts to replicate a published index of bonds by purchasing all of the bonds in the index. *See* Kenneth E. Volpert, *Managing Indexed and Enhanced Indexed Bond Portfolios*, in *THE HANDBOOK OF FIXED INCOME SECURITIES* 887 (Frank J. Fabozzi ed., 6th ed. 2001). In such case, very little investment analysis is required—if the company has a bond in the index, the manager simply purchases the same bond in an effort to duplicate the attributes of the index. *See id.* At the other end of the spectrum, if a portfolio manager employs an "active management strategy" and selects bonds on a day-to-day basis, an analyst may engage in credit and/or valuation analysis, where individual bond and company analysis is essential. *See* REILLY & BROWN, *supra* note 6, at 593-97.

For purposes of this Note, it is assumed that an institution manages somewhere in the middle. Further, it is assumed that a manager invests a portfolio in corporate bonds. *See supra* note 7. For thorough coverage of fixed-income portfolio management strategy and individual fixed-income securities, see *THE HANDBOOK OF FIXED INCOME SECURITIES* (Frank J. Fabozzi ed., 6th ed. 2001), or the most recent edition thereof.

208. Like with bond portfolios, stock portfolios may be managed "passively" or "actively." *See* REILLY & BROWN, *supra* note 6, at 802. In its purest form, in passive management, often referred to as indexing, a portfolio manager purchases all the securities of an index in an effort to mirror the attributes of the index. *Id.* at 804. In such case, no individual stock analysis is performed. However, to make comparisons between information needs of fixed-income and equity analysts meaningful, this Note assumes that equity analysts operate under a predominantly active management scheme that focuses on individual stock selection. *Id.* at 806.

209. Other than equity-derivative instruments, which include warrants, puts, and calls, common stock is the only "security-level" option for managers of pure equity portfolios. *Cf.* REILLY & BROWN, *supra* note 6, at 82-84.

210. *See* REILLY & BROWN, *supra* note 6, at 802.

211. *See id.* at 78-80; *see also* Frank J. Fabozzi et al., *Overview of the Types and Features of Fixed Income Securities*, in *THE HANDBOOK OF FIXED INCOME SECURITIES*, *supra* note 207

In addition to general industry, economy, and issuer analysis, fixed-income security analysts perform a further evaluation that is based on a combination of issuer- and security-level concerns. Security-level analysis is driven, first, by the general type of fixed-income security and, second, by the great degree of variation of individual securities within general categories. Unlike common stock, even a single company "can have many different bond issues outstanding at the same time" and such issues may differ with respect to payment risk and prospective legal remedies against the issuer.²¹² For example, even beyond general differences in maturity and interest rate, the structure of a corporate bond issued in 1997 by General Electric Corporation may be very different than a corporate bond issued by the same company in 1998. General Electric may pledge certain real estate as collateral for one issue and credit card receivables or equipment for a subsequent issue.²¹³ On the other hand, the company may issue an unsecured bond that is only supported by the issuer's promise to pay.²¹⁴ The potential variance of bond issues within a single general class is seemingly infinite. A bond's indenture, the "legal document that defines the rights and obligations of the borrower and the lender,"²¹⁵ may include a provision for a sinking fund, under which the issuer is required to systematically reduce the outstanding principal of the bond throughout its life.²¹⁶ Or, the indenture may provide that the issuer can "call," or effectively repurchase, the bond at a certain price on a specified date or simply at the issuer's discretion.²¹⁷

Although the structures of corporate bonds can be complicated, the structure of asset-backed securities ("ABS") and mortgage-backed securities ("MBS") reach a far greater level of complexity. A MBS "is an instrument whose cash flow depends on the cash flows of an underlying pool of mortgages."²¹⁸ MBS take one of three general forms: "(1) mortgage pass-through securities, (2) collateralized mortgage obligations, and (3) stripped mortgage-backed securities."²¹⁹ While the majority of mortgage-backed securities are backed by residential mortgages, commercial mortgage-backed securities are backed by income from "office space, retail property, industrial facilities, multifamily housing, and hotels."²²⁰ In addition to varying collateral types, MBS may be structured so that there are multiple classes, for which the distribution and timing of principal and interest payments to bondholders may vary.²²¹ For the purposes of this Note, it suffices to observe that, based on this general structure, issuers have developed countless innovative and exceedingly complex MBS

at 3-20.

212. REILLY & BROWN, *supra* note 6, at 492.

213. *See id.* at 492, 510.

214. *See id.* at 492.

215. Jane Tripp Howe, *Credit Analysis for Corporate Bonds*, in THE HANDBOOK OF FIXED INCOME SECURITIES, *supra* note 207, at 417, 436.

216. REILLY & BROWN, *supra* note 6, at 548.

217. *Id.* at 492, 548.

218. Frank J. Fabozzi et al., *Overview of the Types and Features of Fixed Income Securities*, in THE HANDBOOK OF FIXED INCOME SECURITIES, *supra* note 207 at 17.

219. *Id.*

220. *Id.* at 18.

221. *Id.* at 19.

structures to provide different degrees of payment risk and asset/liability matching features to suit the needs of institutional investors.²²²

ABS are similarly complex structured finance instruments. ABS cash flows are determined by the cash flows of underlying non-mortgage assets.²²³ Like MBS, ABS have been structured with multiple classes of bonds for which the timing of interest payments vary.²²⁴ Additionally, ABS further illustrate a fixed-income analyst's information requirements because of the breadth of their potential underlying collateral. ABS may be supported by "credit card receivables, home-equity loans, manufactured homes, [] automobile loans[,] . . . student loans, boat loans, equipment leases, recreational vehicle loans, . . . and, possibly, the future royalties of your favorite entertainer."²²⁵

A bond's structural variables, combined with the quality of the issuer and the condition and direction of the overall economy, determine a bond's risk premium.²²⁶ A bond's risk premium reflects the incremental interest that an issuer must pay bondholders to compensate for the risk of the individual bond issue.²²⁷ Therefore, in addition to predicting how a company's sales, competition, new products, and management will influence a company's future earnings and general financial health, a fixed-income analyst must predict how these and other factors, when combined with the structure of an individual security issue, will impact bond valuations and cash flows.

These factors drive a bond analyst's unique and extensive information requirements. For example, as discussed above, the collateral that supports a bond varies widely. Thus, General Electric may have a bond supported by credit card receivables, commercial property, or its commercial aircraft fleet. If an analyst is evaluating a General Electric commercial mortgage-backed security, the analyst will want to evaluate the extent to which the underlying properties are diversified across geographical regions and property types.²²⁸ General corporate bond analysis requires similarly extensive analysis. If a bond's indenture provides that a company's commercial aircraft fleet serves as the sole collateral for the bond issue, an analyst will be greatly concerned about the number and type of planes, the physical condition of the planes, and the general service procedures and insurance policies for damage to the planes. Additionally, corporate bond indentures may provide "limitation[s] on the issuance of additional debt, sale and leasebacks, and sinking-fund provisions."²²⁹ Accordingly, an analyst must evaluate how these indentures provide protection for

222. *Id.*; see also Lehman Brothers Inc. Mortgage Research Group, *Collateralized Mortgage Obligations*, in THE HANDBOOK OF FIXED INCOME SECURITIES, *supra* note 207, at 619-21.

223. Frank J. Fabozzi et al., *Overview of the Types and Features of Fixed Income Securities*, in THE HANDBOOK OF FIXED INCOME SECURITIES, *supra* note 207 at 19-20.

224. *Id.* at 20-21.

225. *Id.* at 20.

226. REILLY & BROWN, *supra* note 6, at 547.

227. *See id.* at 547-48.

228. See Anthony B. Sanders, *Commercial Mortgage-Backed Securities*, in THE HANDBOOK OF FIXED INCOME SECURITIES, *supra* note 207, at 663, 669-72.

229. Jane Tripp Howe, *Credit Analysis for Corporate Bonds*, in THE HANDBOOK OF FIXED INCOME SECURITIES, *supra* note 207, at 437.

bondholders, and the extent to which they might “hinder the efficient operation of the company.”²³⁰

In sum, a fixed-income analyst’s information needs are extensive and often unique to fixed-income analysis. Indeed, it is likely that much of the information required by fixed-income analysts is not “material” under Regulation FD. However, because of the regulation’s ambiguous definition of materiality and the resulting fear of liability, an issuer that is willing to provide requested information will likely disclose in a manner that complies with Regulation FD.

*C. The Suitability of Compliant Disclosure Methods for
Disclosure of Information Important to Fixed-Income Analysts*

The preceding subparts A and B collectively discussed the likelihood and consequences of a decrease in issuer communication that might result from “chilling.” In addition to the direct decrease in issuer disclosure that might result from chilling, Regulation FD may restrict the quality of information available to analysts because of its disclosure regime. That is, by restricting disclosure to those avenues that are meant to achieve full, public disclosure, an analyst may be unable to obtain the same quality of information as he could before Regulation FD.

Prior to Regulation FD, the unique information needs of fixed-income analysts were necessarily satisfied through one-on-one meetings with issuers.²³¹ Commentators from the bond markets have expressed a concern that Regulation FD would eliminate such meetings.²³² Regulation FD’s restrictive disclosure channels are unlikely to allow fixed-income analysts to reach the type and degree of information that is unique and essential to meaningful bond analysis. In its recent statement to the House Subcommittee hearing on Regulation FD, the Bond Market Association explained the difficulty that high-yield bond analysts have experienced:

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 questions—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 issues²³³

In addition to the probative insufficiency of Regulation FD compliant disclosure avenues, such restrictive disclosure methods have forced bond analysts to compete for the limited time of public webcasts and calls, and have made it difficult to obtain the unique information that fixed-income analysts require.²³⁴

230. *Id.*

231. See AIMR Letter, *supra* note 108.

232. *Id.*

233. *Regulation FD Hearing, supra* note 199 (written statement submitted by The Bond Market Association).

234. *Id.* (testimony of H. Perry Boyle, Jr.).

Confidentiality agreements are the clearest way to avoid Regulation FD's strict disclosure regime. Under Rule 100(b)(2)(ii)²³⁵, Regulation FD does not apply to disclosures made "[t]o a person who expressly agrees to maintain the disclosed information in confidence."²³⁶ However, it is likely that analysts will be reluctant to enter into such agreements for fear of insider trading liability.²³⁷ Specifically, by expressly agreeing to maintain issuer information in confidence, an analyst is under an explicit "duty" to abstain from trading or disclose the information.²³⁸

In sum, Regulation FD may hinder an analyst's ability to "ferret out and analyze information."²³⁹ A fixed-income analyst that is unable to obtain quality, bondholder specific issuer information will be less able to evaluate a bond issue's risk and the related predictability of the income that the bond will generate. Because of the nature of typical fixed-income investors, the consequences of resulting errors will extend beyond the coffers of wealthy institutions.

D. Who is Harmed by a Decrease in Issuer Disclosure to Fixed-Income Analysts?

As previously discussed, even a slight "chilling" in issuer communication may severely impair a fixed-income analyst's ability to evaluate investments.²⁴⁰ This consequence is compounded by the unsuitability of Regulation FD compliant disclosure channels for fixed-income analysis. Regardless of the cause or extent of any decrease in issuer disclosure, any such decrease will make it more difficult for analysts to prudently evaluate fixed-income investments. The purpose for which bonds are often owned and the resulting types of institutions that purchase bonds may effect a transfer of such risk to the public that Regulation FD strives to protect.

As previously discussed, because of their complexity and prohibitively high minimum denominations, individuals rarely participate in the bond market.²⁴¹ However, institutions do not participate by default. Rather, institutions purchase fixed-income securities instead of stocks because of the unique attributes of bonds. Common stock represents a percentage ownership in the issuing entity, and

235. Regulation FD, 17 C.F.R. § 243.100(b)(2)(ii) (2001).

236. *Id.*

237. *See, e.g., Regulation FD Hearing, supra* note 199 (written statement submitted by The Bond Market Association) (observing that "issuers have generally found it difficult to obtain confidentiality agreements from prospective [private placement] investors.").

238. LATHAM & WATKINS, *supra* note 169, at 54.

239. 21 *S.E.C. Docket* 1401, 1406 n.18 (1981), quoted in, *Dirks v. SEC*, 463 U.S. 646, 658 (1983).

240. The extent to which Regulation FD will chill issuer communication will, in part, depend on how aggressively the SEC will go after violations generally, and with how much vigor the SEC will go after borderline cases. The Director of the SEC's Division of Enforcement has stated that Regulation FD will not be treated as a "trap for the unwary[.]" and that the SEC is "not going to second-guess close calls regarding the materiality of a potential disclosure." Richard H. Walker, *Speech by S.E.C. Staff: Regulation FD—An Enforcement Perspective, Remarks to the Compliance and Legal Division of the Securities Industry Association* (Nov. 1, 2000), available at <http://www.sec.gov/news/speech/spch415.htm>.

241. REILLY & BROWN, *supra* note 6, at 497.

stockholders share in the issuer's triumphs and failures.²⁴² In contrast, fixed-income instruments represent a loan by the security purchaser to the issuing company and, "[i]n return, the borrower promises to make periodic interest payments and to pay back the principal at the maturity of the loan."²⁴³ Indeed, many fixed-income securities are very liquid and may be bought and sold, like stock, to achieve gains.²⁴⁴ However, institutions commonly purchase fixed-income securities for their income and risk attributes.

For example, a defined-benefit pension plan "promise[s] to pay retirees a specific income stream after retirement."²⁴⁵ The goal of a pension fund's portfolio manager is to invest employee and company contributions in a way that will satisfy the plan's projected future obligations.²⁴⁶ To effect this goal, a pension fund portfolio manager may use plan contributions to construct a "portfolio of bonds that will provide a stream of payments from coupons, sinking funds, and maturing principal payments that will exactly match . . . specified liabilit[ies]."²⁴⁷ Therefore, in addition to using fixed-income securities to generally create income, a pension fund portfolio manager relies on the varying cash flow structures of bonds to create a portfolio that, when taken together, will generate predictable income.

Insurance companies are another example of an institution that relies on fixed-income securities for their income characteristics. An insurance company operates by investing policy premiums in a way that generates more income than will be necessary to cover projected policy claims.²⁴⁸ Similar to a defined-benefit pension fund, an insurance company uses fixed-income instruments to generate predictable income to support a schedule of liabilities.²⁴⁹

In addition to purchasing fixed-income securities for their income attributes, many institutions invest in bonds because of their relatively low risk profiles. Between 1926 and 1995, the standard deviation, a commonly used indicator of risk, of the average annual large company stock return was 20.3%, and the standard deviation of small company stock return was 34.6%.²⁵⁰ In stark contrast, the standard deviation of long-term corporate bond returns was only 8.4%.²⁵¹ Legislative bodies have recognized the relatively low risk of bond ownership and have "encouraged" certain institutions to use fixed-income securities. For example, a pension fund "must be managed in accordance with ERISA, the Employee Retirement Income Security Act."²⁵² Under

242. *Id.* at 82.

243. *Id.* at 78.

244. For example, a portfolio manager that focuses strictly on a bond's valuation might "buy the undervalued issues and ignore or sell the overvalued issues." *Id.* at 595.

245. *Id.* at 52.

246. *See id.*

247. *Id.* at 607. Since pension funds have little tax liability and have relatively long-term liabilities, they often invest in long-term corporate and government bonds and high-yield securities. *Id.* at 497.

248. *Id.* at 53.

249. *See id.* at 53-54.

250. *Id.* at 58.

251. *Id.*

252. *Id.* at 52.

ERISA,²⁵³ only investments that, when viewed in light of the overall investment portfolio, would be purchased by a “prudent man” may be used.²⁵⁴ Since the goal of a pension plan is to provide financial security for retirement, bonds are commonly the “prudent” investment. Insurance company investments are similarly constrained. The National Association of Insurance Commissioners has established a ranking system for the risk levels of stocks and bonds.²⁵⁵ Pursuant to state Risk Based Capital Standards, insurance companies with “excessive investments in higher-risk categories must set aside extra funds in a mandatory securities valuation reserve . . . to protect policyholders against losses.”²⁵⁶ Therefore, to avoid committing essential capital to valuation reserves, an insurance company is “encouraged” to invest in lower-risk bond portfolios.

Insurance company and pension fund investment portfolios present the clearest example of the types of institutions that invest in fixed-income securities. However, because of a bond’s risk and income attributes, they may be used by any institution seeking to generate a predictable, low-risk stream of income. Other types of institutions that may use such income include charitable and educational endowments, banks, and fixed-income mutual funds.²⁵⁷

With these types of institutions, the public will share the risk that Regulation FD will impair fixed-income investment analysis. Certainly, an insurance company’s bottom line will suffer if it is unable to generate more income than that which is required to pay its liabilities. However, the policyholders will share the loss if the investment portfolio is unable to generate the income required to pay claims. Such a scenario is even clearer with pension funds, an essential source of financial security for retirees. Additionally, a charitable or educational endowment’s inability to provide current income will reduce grant funding, scholarships, and general operating income for such entities. In sum, although the SEC is attempting to protect individual investors and the public through Regulation FD, the SEC has overlooked those “investors” that indirectly benefit from, and depend on, fixed-income security ownership.

E. Cost of Increased Public Disclosure of Fixed-Income Material

As previously covered, the information needs of fixed-income analysts are very significant. This, in addition to the absence of a clear materiality standard in Regulation FD, is likely to lead to massive disclosure costs if issuers continue to provide pre-Regulation FD levels of information to fixed-income analysts. Additionally, as a Form 8-K filing is the only clear way to comply with the regulation’s disclosure requirements,²⁵⁸ the number of Form 8-K filings will increase

253. Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 (1994).

254. REILLY & BROWN, *supra* note 6, at 57.

255. *Id.* at 53.

256. *Id.*

257. *Id.* at 51-55, 497.

258. Beyond a Form 8-K filing, Regulation FD does not specify the measures that are reasonably “designed to provide broad, non-exclusionary distribution of information to the public.” 17 C.F.R. § 243.101(e) (2001). *See supra* text accompanying note 149.

dramatically.²⁵⁹

The SEC concedes that the number of Form 8-K filings will likely increase and that there are expenses related to such filings.²⁶⁰ In its final rule release, the SEC estimated that, under Regulation FD, there will be a total of 65,000 disclosures per year at a cost of between \$538 and \$763 each—in aggregate, an annual cost of between \$35 million and \$49.6 million.²⁶¹ These estimates are based on the assumption that issuers subject to the regulation will make, on average, five disclosures a year.²⁶² However, this assumption is only supported by further, non-empirical assumptions. The SEC reasoned that “five disclosures reflects [sic] the need to make one FD disclosure per quarter, and allows for one additional miscellaneous disclosure.”²⁶³ The SEC further “reasoned” that disclosure needs may vary and that “[s]ome issuers may average more annual FD disclosures . . . [and others], depending on their industry, shareholder composition, or level of analyst coverage, may make fewer if any FD disclosures annually.”²⁶⁴ These “factors” led the SEC to “believe that five is a reasonable estimate.”²⁶⁵

Recent data suggests that the SEC’s assumptions and estimates may be wildly inaccurate. The Securities Industry Association (“SIA”) has recently estimated that Regulation FD will cost issuers and securities firms between \$250 million and \$400 million,²⁶⁶ a far cry from the SEC’s high estimate of \$49.6 million.²⁶⁷ Much of this expense, the SIA reports, comes from the costs of making “materiality” decisions.²⁶⁸ A cursory review of legal websites suggests that law firms have been quick to offer their advice. Only twenty-three days after Regulation FD was enacted, Latham & Watkins, recognizing the lack of agreement among firms on how to advise clients to comply with the regulation, published a table summarizing the recommendations of twenty-two law firms.²⁶⁹ Given the ambiguity in Regulation FD and the resulting fear of liability, law firms are likely to play a large, and very expensive, role in advising companies on how to comply with the regulation. Additionally, beyond consulting on general disclosure policies, it is possible that companies will rely on law firms to advise on ongoing “materiality” decisions.

CONCLUSION

Regulation FD’s goal of leveling the playing field for individual investors and

259. See 17 C.F.R. § 243.101(e)(2).

260. Final Rule Release, *supra* note 3, at 51,731-33.

261. *Id.* at 51,732.

262. *Id.* at 51,731.

263. *Id.* at 51,732.

264. *Id.*

265. *Id.*

266. Securities Industry Association, Costs and Benefits of Regulation Fair Disclosure 5 (May 18, 2001).

267. See *supra* note 261 and accompanying text.

268. Securities Industry Association, Costs and Benefits of Regulation Fair Disclosure 5 (May 18, 2001).

269. LATHAM & WATKINS, *supra* note 169, at 87-92.

ensuring investor confidence in the integrity of the market is commendable. However, the SEC has underestimated, or simply disregarded, the scope of the regulation and its potential side effects. Although the predominant focus of Regulation FD was to eliminate selective disclosure in the equity market, it equally applies to, and may have severe consequences for, the fixed-income market.

Regulation FD was enacted to assure that issuer disclosure of "material" information does not precede disclosure to the investing public. However, because of the regulation's unclear "materiality" standard, Regulation FD may reduce issuer communication instead of remedying any unfairness in its distribution. Even absent this "chilling" effect, by restricting issuer and analyst communication to those methods that are likely to achieve full public disclosure, a fixed-income analyst will likely be unable to obtain pre-Regulation FD levels of issuer information. Because of a fixed-income analyst's unique information needs, even a minor reduction in quality issuer information will impair an analyst's ability to effectively evaluate fixed-income instruments.

Because of the nature of the institutions that purchase the majority of fixed-income instruments, institutions will not bear the full consequence of imprudent investment decisions. Regulation FD may harm both institutions *and the public* by impairing the ability of institutions to use fixed-income investments as a low-risk tool for generating predictable streams of income to fund insurance policies, endowments, charitable trusts, and pension funds.