Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

A Reg FD Reminder From Social Media

Law360, New York (June 18, 2012, 1:14 PM ET) -- A chief financial officer's recent misstep highlights the U.S. Securities and Exchange Commission's rule against selective disclosure of corporate information in connection with electronic communications with investors. On May 14, 2012, Francesca's Holdings Corporation announced the termination of its CFO based on a finding that he had improperly communicated company information through social media. Published news reports indicate the CFO made a comment on Twitter that said "Board meeting. Good numbers = Happy Board" during a quiet period prior to its planned earnings release. Francesca's terminated the CFO after an internal investigation.

Francesca's acted quickly against the backdrop of recent SEC enforcement activity in highly publicized insider trading cases. According to a recent Wall Street Journal article, federal prosecutors have secured nearly 60 convictions or guilty pleas in insider trading cases in the last three years. In light of the Francesca's incident, public companies and their officers should be mindful of the enforcement mechanism — Regulation FD (fair disclosure) or Reg FD as it is commonly known — which can be used to deter the selective disclosure of material nonpublic information without resort to insider trading principles.

The SEC has enforced this rule infrequently since it was promulgated a decade ago, with only a handful of reported settlements and a single reported judicial decision. When the rule was promulgated the SEC specifically noted that, while companies previously relied on analysts to convey information to the market, advances in technology provide effective avenues for companies to communicate directly with investors and avoid selective disclosure to intermediaries. Indeed, Reg FD has been cited as one factor behind the pervasive use of webcasts to disclose earnings reports and other investor-related events.

In its most recent settlement against a corporation under Reg FD, the SEC acted on the selective disclosure of information regarding Fifth Third Bancorp.'s decision to redeem a class of trust preferred securities with notice to the beneficial holders of the securities through a system available only to Depository Trust Company (DTC) members and subscribers, but not to the general public. Therefore, anyone without access to the DTC system would not have been aware of the planned redemption.

At the time, the securities were trading at a premium to the redemption price. The SEC concluded that Fifth Third violated Reg FD because it "failed to consider how its decision to redeem the securities would affect investors in the market for those securities." In re Fifth Third Bancorp, Release No. 65808 (Nov. 22, 2011).

The Structure of Reg FD

Reg FD seeks to prevent the selective disclosure of material nonpublic information by requiring, in the event of either intentional or inadvertent disclosure, that the company make a public disclosure of the same information. The corrective disclosure must be "simultaneous" if the disclosure is "intentional." A disclosure is defined as intentional where "the person making the disclosure either knows, or is reckless in not knowing, that the information … is both material and nonpublic." 17 C.F.R. § 243.101(a).

If, on the other hand, the disclosure is inadvertent, then the company is required to make the information public "promptly." The regulation defines "promptly" as "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 the disclosure. 17 C.F.R. § 243.101(d). Corrective disclosures can be made by filing a Form 8-K or by disseminating the information by any method "reasonably designed to provide broad, non-exclusionary distribution of the information to the public." 17 C.F.R. § 243.101(e).

Reg FD directly applies only to issuers of securities. In cease-and-desist proceedings, the SEC proceeds against individuals as a "cause of" the violation. Where the SEC proceeds against individual executives in injunctive actions, it alleges aiding and abetting liability under Section 20(e) of the Securities Exchange Act of 1934. In these cases, the SEC's theory of liability against individuals is that, by making a selective disclosure, they caused, or aided and abetted, the company's Reg FD violation.

As in insider trading cases, liability under Reg FD depends on whether the information is "material." This term is not defined in the regulation. When it announced the rule, the SEC specifically deferred to existing definitions in case law. However, the commission has articulated a nonexhaustive list of events or circumstances that may be material in the context of Reg FD: "(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." 65 Fed. Reg. 51721 (Aug. 24, 2000).

Unlike SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, Reg FD does not impose liability or any affirmative obligation on outsiders who receive nonpublic information, regardless of how that information is conveyed. Thus, a violation of this rule does not necessarily give rise to insider trading liability. On the other hand, the SEC has made clear that Reg FD "does not affect any existing grounds for liability under Rule 10b-5," and outsiders receiving disclosures (as well as insiders who make them) still face insider trading liability in appropriate circumstances.

In commentary accompanying the final version of Reg FD, the SEC stated that "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," i.e. the discloser intends to confer a personal benefit on the person to whom the disclosure is made. Additionally, the SEC noted that an "issuer's contacts with analysts may lead to liability under the 'entanglement' or 'adoption' theories" under that same rule. 65 Fed. Reg. 51726 (August 24, 2000).

Enforcement Actions Under Reg FD

Since 2000, reported actions have been brought against a total of 11 companies and 12 associated individuals. Only one Reg FD action has resulted in a judicial decision: SEC v. Siebel Sys. Inc., 384 F. Supp. 2d 694 (S.D.N.Y. 2005). In Seibel, the SEC alleged that the company violated Reg FD by failing to make required disclosures after providing material nonpublic information to groups of investors at dinner meetings. The SEC charged the company's chief financial officer and its director of investor relations with aiding and abetting the violation through their disclosures at the meetings. The SEC compared public and private statements made by the executives and alleged that, by virtue of their conduct, the company selectively disclosed material nonpublic information without making corrective disclosures.

The U.S. District Court for the Southern District of New York disagreed and dismissed the entire action. The court stated that there was no support in Reg FD or its proposing or adopting releases for the SEC's approach. "In examining publicly and privately disclosed information, the SEC has scrutinized, at an extremely heightened level, every particular word used in the statement, including the tense of verbs and the general syntax of each sentence." 384 F. Supp. 2d at 704.

The court concluded that "[t]he nature and content of the statements that the SEC alleges violate Regulation FD do not support the commission's claim that Siebel Systems or its senior officials privately disclosed material nonpublic information." Id. at 694. The court explained that "[t]o be deemed to be material, the statements must contain information of reasonable specificity to impart a definite indicia of performance; and a statement is not material if it constitutes nothing more than a vague assertion on which no reasonable investor would rely." Id. at 709 n.15.

Apart from Seibel, the SEC has initiated Reg FD actions in situations where company officers, including investor relations personnel, have made specific disclosures to analysts and/or investors. In most of these cases the selective disclosure was clearly material and nonpublic. In several of these settlements, company officers engaged in one-on-one calls or emails to analysts, in which the company communicated that earnings estimates would not be met.

Half of the companies agreeing to Reg FD settlements with the SEC have not been assessed penalties. Similarly, just over half of the settlements with individuals included civil penalties. To date, the most common penalty assessed to individuals has been $50,000.

Reg FD provides the SEC with an enforcement mechanism that does not depend on the proof of intent necessary to support insider trading actions. These recent cases are a reminder of the care that must be taken by companies disclosing financial information to their investors, especially when they use electronic media, and that errors in disclosure can be actionable even when inside trading is not at issue.

--By R. J. Cinquegrana and John R. Baraniak Jr., Choate Hall & Stewart LLP

R. J. Cinquegrana co-chairs Choate's litigation department and government enforcement and compliance practice group in Boston. John Baraniak is a partner in the firm's litigation department in Boston.