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SECURITIES REGULATION IN THE ELECTRONIC AGE CONFERENCE

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TABLE OF CONTENTS

	<u>Page</u>
I. INTRODUCTION.....	1
II. COMMUNICATIONS WITH ANALYSTS AND THE FINANCIAL PRESS.....	3
A. Impact Of The Private Securities Litigation Reform Act on The Intent Standard Governing Corporate Communications	5
B. Direct Liability For Statements To Analysts	9
1. Representative Cases	9
a. Company Statements Made Directly to Analysts	9
b. Anonymous Statements Made to Analysts	10
C. Selective Disclosure To Analysts	13
D. Statements In Analyst Conference Calls	16
E. Reviewing, Approving And/Or Adopting Analyst Reports	19
1. The Pre-Publication "Entanglement" Theory.....	19
a. The "Bright Line" Rule	20
b. The "Two-Way Flow of Information" Rule.....	22
2. Post Publication "Adoption" of Analyst Reports.....	26
3. Recent Cases in the Ninth Circuit.....	28
F. Impact Of Disclosures To Analysts On Periodic SEC Filings	43
III. THE SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS	44
A. Background	44
1. Initial SEC Attempts to Encourage Publication of Forward- Looking Statements	44
2. The "Bespeaks Caution" Doctrine	45

B.	The Statutory Safe Harbor Under The Reform Act	47
C.	Judicial Interpretations	48
1.	"Meaningful Cautionary Statements"	48
2.	"Actual Knowledge" Standard	51
D.	Practical Impact of Safe Harbor	52
1.	Quantity of Forward-Looking Information	52
2.	Quality of Forward-Looking Information Being Provided	52
IV.	PROPOSED SEC SELECTIVE DISCLOSURE AND INSIDER TRADING RULES	53
A.	Selective Disclosure — Proposed Regulation FD	54
1.	Timing and Mechanics	55
2.	Materiality.....	56
3.	Safeguards.....	56
4.	Relationship with the Securities Act.....	57
B.	Clarification of Insider Trading Prohibitions – Proposed Rules 10b5-1 and 10b5-2.....	58
1.	Use/Possession.....	58
2.	Misappropriation Based on Family or Personal Relationships.....	61
C.	What Companies Should Do Now.....	62

I. INTRODUCTION

Twenty-three years ago, the Second Circuit Court of Appeals compared corporate communications with securities analysts and the financial press to "a fencing match conducted on a tightrope."¹ The relationship between companies and analysts remains a hot topic among securities regulators, industry leaders and plaintiffs' securities class action lawyers. SEC Chairman Arthur Levitt, for example, has stated that selective disclosure is "a high priority" for SEC enforcement actions,² and recently characterized the "behind the scenes" dissemination of information to analysts as "a stain on our markets."³

In the past few months, several public companies have been sued for allegedly having selectively disclosed material — and previously nonpublic information — to analysts and/or favored investors. For example, in October, a Silicon Valley company and its officers were sued for alleged selective disclosure of an impending earnings "surprise."⁴ Another company, Abercrombie & Fitch, is the subject of a number of securities class action suits — and now an SEC investigation — for alleged selective disclosure of "sluggish" sales to a Lazard Freres & Co.

¹ *SEC v. Bausch & Lomb Inc.*, 565 F.2d 8, 9 (2d Cir. 1977).

² "Chats With Analysts May Give Unfair Edge," *USA Today*, Mar. 9, 1998, at 8B.

³ *Quality Information: The Lifeblood of Our Markets*, Remarks by SEC Chairman Arthur Levitt, U.S. Securities and Exchange Commission, to the Economic Club of New York City, Oct. 18, 1999.

⁴ *Tucci v. Hi/fn, Inc., et al*, C-99-4531-SI (N.D. Cal. filed October 8, 1999) (alleging that a \$32 share stock price decline was due to unlawful selective disclosure of bad news to "certain individuals").

analyst five days before the company publicly announced its 1999 third quarter results.⁵ The recent travails of Webvan in connection with its aborted IPO similarly highlight issues concerning selective disclosure during the so-called "quiet period" preceding an IPO. These are just a few recent examples of how companies are exposed to shareholder suits and regulatory investigations as a result of their sometimes casual — or unwitting — adoption of and entanglement with analyst research reports, and their disclosures in the ubiquitous analyst conference calls most companies hold in conjunction with an earnings release.⁶

In response to its growing concern about selective disclosure of material nonpublic information, the SEC recently issued new proposed regulations governing the process for issuer release of such information. The proposed regulations would, among other things, require simultaneous public disclosure — through means intended to effect widespread distribution — whenever information is disclosed to one or more persons outside the corporation, *e.g.*, to market analysts and institutional investors. In the same proposing release, the SEC proposed new rules intended to "clarify and strengthen" insider trading laws by establishing that trading by an insider while he or she is aware of material nonpublic information will give rise to liability except in carefully circumscribed situations and by establishing that certain familial relationships presumptively give rise to an expectation of privacy under the misappropriation theory of insider trading.

⁵ "Abercrombie & Fitch Ignites Controversy Over Possible Leak of Sluggish Sales Data," *Wall Street Journal*, Oct. 14, 1999, at C1; "SEC Investigates Possible Disclosure At Abercrombie," *Wall Street Journal*, Nov. 16, 1999, at C22.

⁶ "Trading Picks Up During Conference Calls, Evidently Leaving Small Investors On Hold," *Wall Street Journal*, Mar. 6, 1997, at C2.

This paper provides a brief summary of recent legislative, regulatory and judicial developments that may affect public companies' dealing with analysts and the financial press, particularly in relation to quarterly earnings and material corporate news. Although the SEC may shortly supersede our guidance in some of these areas if it adopts its proposed regulations in their current form, we expect that there still will be much room for interpretation and debate as to how companies may — or may not — communicate with the street.

II. COMMUNICATIONS WITH ANALYSTS AND THE FINANCIAL PRESS

Public companies communicate with "the street" in a myriad of ways. Besides earnings announcements and quarterly SEC filings, most companies also conduct analyst conference calls, attend and make presentations at industry conferences, host meetings with institutional investors, give interviews to the financial press and wire services, post announcements and other news on corporate websites, and talk to individual shareholders through investor relations personnel. A recent study commissioned by the National Investor Relations Institute ("NIRI") found that in 1998, almost *ninety percent* of companies surveyed always or usually review and comment on drafts of analyst research reports, and the vast majority of companies also review analyst earnings estimates prior to their publication.⁷

⁷ "Issues in Investor Communications and Corporate Disclosure," a study conducted for NIRI by Rivel Research Group (May 1998). A copy of the NIRI study is attached as an Appendix to this paper.

From these various means of communications have sprung a veritable cottage industry of rumors, "whisper" estimates, and leaks of material corporate information,⁸ all of which ultimately form the basis for many securities class actions and SEC enforcement inquiries. From our experience in the last decade, several trends — both good and bad — emerge from the many cases brought against public companies over their communications with the street. Most of these trends are remarkable for their persistence, despite years of counseling and corporate compliance programs:

- many companies still believe that disclosures other than in the form of a press release or earnings announcement somehow are not "real," and cannot be actionable;
- many corporate executives think that using superlatives and adjectives in their speeches and press releases ("record results," "strong demand") is just good marketing, and won't be misconstrued in a court case;
- a number of CFOs still think it is good practice to try to "talk the street down" when an earnings surprise is anticipated, by conducting one-on-one meetings or phone calls with analysts;
- a few CEOs think they are helping the company's credibility by giving advance notice of material corporate news to selected analysts;
- most companies do nothing to document the basis for any guidance given by their senior executives to the investment community; and
- many companies are still talking to the street late in the quarter, when a self-imposed "quiet period" should otherwise be in effect.

Despite these persistent trends, we suggest that there are opportunities for public companies to improve their disclosure practices, stop the kind of conduct that might be deemed

⁸ "Traders Laugh Off The Official Estimate On Earnings, Act On Whispered Number," *Wall Street Journal*, Jan. 16, 1997, at C1; "Web Site Posts The Earnings Estimates That Most Sources Will Only Whisper," *Wall Street Journal*, Oct. 19, 1998, at B15.

to constitute selective disclosure, and reduce the risk of shareholder litigation over failed forecasts. Chief among our conclusions are:

- companies *can* give more formal guidance to the street without risking catastrophic exposure;
- companies *can* make forecasts to the street if they reasonably document the reasons why management believes the forecasts are reliable;
- companies *can* reduce risk by consistently talking to the analyst community about the important factors affecting the company's business, without necessarily making "hard" forecasts and without adopting or entangling itself with analyst research reports; and
- companies *will* need to revamp the whole concept of the quarterly conference call, and make them accessible to "all comers" — but doing so need not lead to market chaos.

We will address each of these opportunities below, beginning with important new developments on the law governing the "intent" standards under which communications with the street will be judged.

A. Impact Of The Private Securities Litigation Reform Act on The Intent Standard Governing Corporate Communications

The Private Securities Litigation Reform Act of 1995 ("Reform Act") raises issues of first impression as to how courts should analyze revenue and earning forecasts or other forward-looking statements, whether contained in company documents or in analyst research reports. Under pre-Reform Act case law, courts routinely analyzed such predictive statements under a "reasonable basis" standard of liability — arguably a standard even *lower* than the recklessness standard articulated by the Ninth Circuit Court of Appeals in *Hollinger v. Titan Capital Corp.*⁹ and similar cases. These pre-Reform Act cases appear to derive the "reasonable basis" standard

⁹ 914 F.2d 1564 (9th Cir 1990).

from SEC Rule 175 under the Securities Act of 1933 ("Securities Act"), which provides a limited safe harbor for forward-looking statements. Under Rule 175, a forward-looking statement is actionable if it is made "without a reasonable basis or was disclosed other than in good faith."

The Reform Act largely makes obsolete Rule 175 as it relates to issuer statements, and arguably also imposes a higher *scienter* standard — *actual knowledge* — for forward-looking statements made in analyst reports that are deemed to have been "adopted" by the issuer. The Reform Act specifically extends the statutory safe harbor to an issuer *or any person acting on behalf of the issuer*, as well as an underwriter who makes a statement *based on information provided by the issuer*. Although an underwriter would not normally agree that it publishes research reports "on behalf of the issuer," that is often *precisely* the theory of liability in securities class actions basing liability on analysts' reports. We submit that many post-Reform Act decisions have incorrectly carried forward a now largely irrelevant standard of *scienter* for judging the actionability of analysts' forecasts, at least in the context of statements that a court finds have been "adopted" by the company.

In most post-Reform Act cases, claims involving allegedly misleading predictive statements in analyst research reports typically are brought against the *issuer*, not the underwriter. Invariably, plaintiffs allege that the issuer has, by its conduct, either (a) made direct misstatements to the analyst, which the analyst repeated to the market in his or her published research report; (b) "entangled" itself with the research report by reviewing and/or correcting it prior to publication, thus making the forecasts its own; or (c) "adopted" the research report after its publication by referring investors to it, sending it to investors, or otherwise embracing it as its own. Each of these three forms of liability raising events contemplate that the forward-looking statements in the analyst report belong to, or originate with, the issuer. By the same token, in

each circumstance, the analyst is alleged to be acting essentially as the agent of the issuer. As such, we believe that the Reform Act's "actual knowledge" standard of scienter for forward-looking statements should apply to analyst research reports that the company is accused of reviewing, approving or adopting.¹⁰

Two other consequences naturally follow from applying the "actual knowledge" standard. First, under the Reform Act, the knowledge in question must be the actual knowledge of an executive officer of the issuer, and specifically knowledge that the statement was false or misleading. Second, under the Reform Act pleading standards, plaintiffs are required to plead facts demonstrating a "strong inference" that the corporation, through its executive officer, made the statement with such actual knowledge. In this regard, the Ninth Circuit recently held *In re Silicon Graphics, Inc. Securities Litigation*¹¹ that a private securities plaintiff proceeding under the Reform Act must plead, in great detail, facts that constitute strong circumstantial evidence of "deliberately reckless" misconduct. These standards obviously would impose a very high bar to any claim based upon such statements in analyst reports, whether or not such statements are

¹⁰ Section 102 of the Reform Act (codified at 15 U.S.C. § 78aa) provides that, in any action arising under the Securities Exchange Act of 1934 ("Exchange Act") that is "based on an untrue statement of material fact or omission of a material fact necessary to make the statement not misleading," a person "shall not be liable with respect to any forward-looking statement, whether written or oral," if the statement was (a) "immaterial;" (b) made "without actual knowledge by that person that the statement was false or misleading," or (c) when identified as a forward-looking statement, "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."

¹¹ 183 F.3d 970, 974 (9th Cir. 1999).

deemed to be forward-looking. Similarly, the Eleventh Circuit, in *Harris v. Ivax Corp.*¹² recently held that the Reform Act imposes an actual knowledge standard on forward-looking statements, *including statements of historical fact intertwined with predictive statements*. The type of stringent pleading standards set forth in *Silicon Graphics* and *Ivax* should reduce the risk substantially of making forward-looking information available to the market.¹³

Notwithstanding these recent judicial interpretations of the Reform Act, the SEC has approached the issue of a corporation's liability for analysts' projections and forecasts without any apparent regard for the Reform Act's "actual knowledge" standard. According to the SEC, liability exists "if an issuer knows, *or is reckless* in not knowing, that the information it distributes is false or misleading," and argues that a corporation "cannot be insulated from liability because management was not actively involved in the preparation of that information."¹⁴ Worse still, the SEC contends that any issuer guilty either of "entanglement" or "adoption" assumes a corollary *duty to correct* material misrepresentations in the analyst report. Thus, according to the SEC, once entangled, an issuer assumes an ongoing obligation to compare its internal, non-public forecasts, projections and actual performance with the "street estimates," and to promptly disclose material adverse information when it first becomes known.

¹² 182 F.3d 799 (11th Cir. 1999).

¹³ Several exceptions under the Reform Act might limit application of the "actual knowledge" standard in an individual case, including the exception that this scienter standard — and the safe harbor generally — does not apply to statements made "in connection with an initial public offering." *See* 15 U.S.C. § 78aa(b).

¹⁴ *In re Presstek, Inc.*, SEC Exchange Act Release No. 39,472, at 9 (Dec. 22, 1997).

B. Direct Liability For Statements To Analysts

Interactions with analysts can give rise to liability for (a) conveying misleading information to analysts for them to disseminate, (b) orally expressing comfort with consensus earnings estimates, and (c) in some cases, making anonymous statements to analysts. As noted above, the SEC in its recent *Presstek* release stated that "[i]f an issuer knows, or is reckless in not knowing, that the information it distributes is false or misleading, it cannot be insulated from liability because management was not actively involved in the preparation of the information."¹⁵ In other words, in the view of the SEC, a company cannot avoid liability for doing indirectly (*i.e.*, make a false statement to an analyst) that which it could not do directly (make a false statement to the market). Following is a brief discussion of representative cases.

1. Representative Cases

a. Company Statements Made Directly to Analysts

In *Cooper v. Pickett*,¹⁶ the Ninth Circuit flatly rejected the argument made by defendant Merisel, Inc. that it could not be held liable for statements made by analysts, even when it admittedly provided some of the information upon which the analyst's reports were based. Relying on its earlier opinion in *Warshaw v. Xoma Corp.*,¹⁷ the Ninth Circuit determined that plaintiffs' allegation that Merisel intentionally had used third party analysts to disseminate false information to the investing public was sufficient to withstand defendants' motion to dismiss. According to the court in *Cooper*, "[i]f this is true, [defendants] cannot escape liability simply

¹⁵ *Id.* at 10.

¹⁶ 122 F.3d 1186 (9th Cir. 1997), *as amended*, 137 F.3d 616 (1998).

¹⁷ 74 F.3d 955 (9th Cir. 1996).

because [they] carried out [their] alleged fraud through the public statements of third parties."¹⁸ This conclusion is not surprising, and several district courts have followed *Cooper v. Pickett* and held that claims could proceed based upon alleged fraudulent statements made by the company directly to analysts.

b. *Anonymous Statements Made to Analysts*

In finding that a corporation could not be held liable for *anonymous* statements in analysts reports or the financial press, the Second Circuit in *Time-Warner, Inc. Securities Litigation*¹⁹ noted that, "[f]ew reporters or analysts would knowingly abet a fraud Additionally, investors tend to discount information in newspaper articles and analyst reports when the author is unable to cite specific, attributable information from the company."

In another case, *Oppenheimer v. Novell, Inc.*,²⁰ the defendant was showing strong sales in 1993 due in part to a new software product. Financial analysts, however, were concerned that Novell was "channel stuffing" (maintaining or increasing revenues by piling up inventory with distributors) and that such activity would lead to decreased sales of other Novell products. The plaintiff alleged that Novell, in order to allay analyst concerns and thus keep the price of the stock high, made a series of misleading statements, which were then communicated to investors via analyst reports and the financial press. Some of these statements were anonymous and some were attributed to an individual corporate officer. The court, citing *Time-Warner*, held that a

¹⁸ 137 F.3d at 624 (quoting *Warshaw*, 74 F.3d at 959).

¹⁹ 9 F.3d 259, 265 (2d Cir. 1993).

²⁰ 851 F. Supp. 412 (D. Utah 1994).

corporation cannot be found liable for anonymous statements.²¹ As for comments made by Novell's Director of Corporate Relations, during an address to a group of analysts (he was quoted as saying, "'we're comfortable with inventories in light of their consistently [sic] with prior periods'" and that he was "comfortable" with analysts' predictions for third quarter earnings), the court held that these comments were only a "positive spin on publicly known facts," and had a reasonable basis, thus making them "not actionable."²²

Both the *Time-Warner* and the *Novell* courts took pains to distinguish *In Re AnnTaylor Stores Securities Litigation*²³ on its facts. In *AnnTaylor*, the defendants claimed that "anonymous" corporate statements were not sufficient under relevant pleading standards. The court denied the defendant's motion to dismiss, stating that, "defendants are in a better position than plaintiffs to know who made the statements Prior to discovery, plaintiffs are not expected to pinpoint precisely who uttered the statements."²⁴ The court explained that to rule otherwise would mean that, "any corporation could avoid liability . . . by simply issuing false statements through an anonymous spokesperson instead of a named officer or director."²⁵

²¹ *Id.* at 416.

²² *Id.*

²³ 807 F. Supp. 990 (S.D.N.Y. 1992).

²⁴ *Id.* at 1004.

²⁵ *Id.*

In contrast to *AnnTaylor*, the Second Circuit in *Time-Warner* required "at a minimum, that the plaintiff identify the speaker of the allegedly fraudulent statements."²⁶ While recognizing that "a scheming corporation could inflate its stock price through fraudulent statements whispered to reporters or analysts," the court concluded that, "for several reasons . . . we have some confidence that this is not a sufficiently likely scenario." *Id.* The Second Circuit went on to explain that:

the effect of a less strict construction of Rule 9(b) would be only to allow discovery on the issue of the linkage between the corporation and the newspaper stories or analysts reports. Sometimes, of course, plaintiff's counsel would be able to use discovery to determine the identity of the speaker But far more often, we suspect, this would not be the case . . . , [i]n which case [the corporation] has been unnecessarily burdened either by the expense of discovery or by a settlement extracted under threat of such discovery.²⁷

Although these cases reflect ambivalence about how pleading standards should apply in the context of *anonymous* corporate statements, none can be read to hold that a false statement made by the company directly to an analyst is not actionable. Indeed, several recent Reform Act cases explicitly have upheld claims alleging that companies used analysts as "conduits" of false

²⁶ 9 F.3d at 265.

²⁷ *Id.* at 265-66.

and misleading statements.²⁸ Companies headquartered in the Ninth Circuit should assume that the decision in *Cooper v. Pickett* is controlling.²⁹

C. Selective Disclosure To Analysts

Disclosures to individual analysts may create potential insider trading problems for corporations. If the analyst or the analyst's clients trade on material and otherwise non-public information, the analyst or the client may be guilty of insider trading. SEC Chairman Arthur Levitt has called this "an increasingly worrisome form of trading on the basis of non-public information," which the SEC is watching very closely. In his view, "calls to analysts should not come before a press release, and that — even then — these discussions should not divulge new material information not contained in that press release. . . . Legally, you can split hairs all you want. But ethically it's very clear: If analysts or their firms are trading — knowing this information, and prior to public release — its just as wrong as if corporate insiders did it."³⁰

The most often cited case in the area of corporate disclosures to analysts is *Dirks v. SEC*,³¹ in which the Supreme Court found that liability for "tipping" material nonpublic information to another who trades on that information requires, among other things, (a) a breach

²⁸ See, e.g., *Bryant v. Apple South, Inc.*, 25 F. Supp. 2d 1372 (M.D. Ga. 1998), *aff'd sub nom Bryant v. Avado Brands, Inc.*, 187 F.3d 1271 (1999); *Robertson v. Strassner*, 32 F. Supp. 2d 443 (N.D. Tex. 1998); *In re Home Health Corp. of Am., Inc. Sec. Litig.*, 1999 WL 79057 (E.D. Pa. 1999); *Molinari v. Symantec*, 1998 WL 78120 (N.D. Cal. 1998).

²⁹ Although the court in *Cooper* applied pre-Reform Act case law — and did not purport to apply Reform Act standards — *Cooper* nevertheless is routinely cited by class action plaintiffs in post-Reform Act cases.

³⁰ *A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading*, Remarks by SEC Chairman Arthur Levitt, U.S. Securities and Exchange Commission at "SEC Speaks" Conference, Feb. 27, 1998.

³¹ 463 U.S. 646 (1983).

of an independent fiduciary duty, and (b) personal benefit to the insider. Recent cases have put a gloss on the *Dirks* holding. In *SEC v. Stevens*,³² for example, the CEO of Ultrasystems made unsolicited phone calls to certain analysts warning them of an impending announcement that quarterly revenues were below expectations.³³ The SEC brought suit against Stevens on the theory that Stevens gained a "reputational" benefit from this prior disclosure. In this regard, the SEC noted that Stevens had been criticized earlier by analysts for allegedly not being candid about Ultrasystems' prospectus and arguably sought to restore his credibility by the "tipping."³⁴ Although this case settled before trial, the concept of insider trading liability based on a selective disclosure (*i.e.*, "tipping") theory — even in the absence of any direct pecuniary benefit — has clearly taken hold and been embraced by the Commission in the years since *Stevens* was settled.

In *SEC v. Rosenberg*,³⁵ the SEC brought suit against an analyst who used inside information, obtained during his preparation of a research report for a registered broker-dealer, to trade on his own account. He did not use the information to trade for client accounts.³⁶ The SEC alleged that he was in "breach of a duty arising out of a relationship of trust and confidence

³² SEC Litig. Release No. 12,813, 48 SEC Docket 739 (Mar. 19, 1991).

³³ *Id.* at 739.

³⁴ *Id.*

³⁵ SEC Litig. Release No. 12,986, 49 SEC Docket 1373 (Sept. 24, 1991).

³⁶ *Id.* at 1373-74.

that he has with [the brokerage firm and its clients].³⁷ This matter also settled prior to judicial resolution.

Besides SEC enforcement actions such as *Stevens* and *Rosenberg*, selective disclosure to analysts has recently been the subject of several private securities class action cases. For example, in *Randall v. Rational Software Corporation*,³⁸ plaintiffs brought federal securities claims against Rational and Cowen & Company, Inc. for selective disclosure. The complaint alleges that Rational leaked adverse corporate news to Cowen on the morning of October 8, 1997, and that Cowen in turn used that information to cause its clients to "dump" their shares that morning. In the early afternoon, a trading halt was announced, and twenty minutes later a Cowen analyst was quoted by Dow Jones as saying he already knew that Rational's near term results were going to be lower than estimated. At the end of the day, Rational finally issued a press release pre-announcing lower-than-expected financial results. Before the trading halt, the stock price declined almost 20 percent. The district court in *Rational Software* granted a motion to dismiss with leave to amend, even though the allegations of "tipping" by the company were very specific as to date and time, and as to the alleged admissions by the Cowen broker that he knew of the adverse information in advance of the market. The court held that allegations that the CEO's disclosures to the Cowen analyst breached the CEO's fiduciary duty were insufficient, and failed to allege what personal benefit the CEO derived from the alleged tipping, beyond generalized allegations of "building goodwill." The plaintiffs' effort to obtain discovery in order to further specify the nature of the alleged selective disclosure was at first upheld by the district

³⁷ *Id.* at 1374.

³⁸ C97-03740 (N.D. Cal., filed Oct. 10, 1997).

court, but later reversed by the Ninth Circuit in *SG Cowen Securities Corp. v. U.S. District Court*.³⁹ It remains to be seen what plaintiffs' counsel will plead on remand.

In *Tucci v. Hi/fn, Inc.*,⁴⁰ plaintiffs similarly alleged that a massive sell-off of the company's shares was precipitated by selective disclosure of bad news to unnamed individuals, resulting in a huge volume of trading and a dramatic decline in the stock price before trading was halted. This case, just filed in October 1999, may signal the beginning of a new trend of "selective disclosure" cases, following on the heels of Chairman Levitt's October 18th speech challenging the practices of public companies with respect to disclosure of material corporate news.

D. Statements In Analyst Conference Calls

As mentioned above, it is not uncommon for companies to provide commentaries and "guidance" in conference calls with analysts, usually in conjunction with the issuance of a press release of the company's earnings for the prior quarter. Questions to corporate executives frequently are raised during such conference calls as to whether those executives are "comfortable" with the analysts' earnings forecasts. The case law is in conflict as to whether a company's expressions of "comfort" with analyst's earnings estimates are actionable. For example, in *In re Adobe Systems, Inc. Securities Litigation*,⁴¹ the plaintiffs claimed that Adobe made misleading public statements that inflated the price of the company's stock. During a conference call with a group of financial analysts, one of the analysts asked the CFO of the

³⁹ 189 F.3d 909 (9th Cir. 1999).

⁴⁰ C-99-4531-SI (N.D. Cal., filed Oct. 8, 1999).

⁴¹ 787 F. Supp. 912 (N.D. Cal. 1992), *aff'd*, 5 F.3d 535 (9th Cir. 1993).

company "how comfortable" he was with the "\$2.25 estimates out there." In response, the CFO stated that "most of those estimates are clustering around \$2.10 or so, and I guess obviously we'd feel more comfortable with that" ⁴² While the court did note that this statement "could well have been considered a projection in the context in which it was made, *i.e.*, a conference with securities analysts," ⁴³ it granted summary judgment for the defendants on the grounds that it was not misleading, despite the fact that internal reports at the time estimated annual earnings per share of \$1.47 to \$1.68, because the internal reports were still uncertain and inconclusive. ⁴⁴ Several recent Reform Act cases have dismissed claims based on statements of "comfort" with analyst forecasts. See discussion of post-publication adoption case law in Section II.E.2, below.

In contrast to *Adobe*, several pre-Reform Act decisions within the Ninth Circuit and elsewhere find similar expressions of "comfort" actionable, or at a minimum find such statements to arguably constitute "adoption" of the analyst forecast. ⁴⁵ Numerous courts have held that a corporate officer expressing comfort with analysts' projections may reasonably be

⁴² *Id.* at 915.

⁴³ *Id.*

⁴⁴ One commentator has noted that *Adobe* indicates the "benefit of using cautionary language if management finds itself in a position where it believes that it must comment on an analyst's projection" — advice that becomes even more relevant if the issuer is eligible for the statutory safe harbor under the Reform Act. This commentator also points out the fact that the CFO's conversation with analysts was on tape, giving the CFO's testimony substantial evidentiary power in court. Philip R. Rotner, "Forward Looking Statements: Three Touchstones from Case Law," *NASDAQ Financial Journal*, Spring 1994, at 19.

⁴⁵ See generally Ronald O. Mueller and Gavin A. Beske, "Cold Comfort: The Risks of Expressing 'Comfort' With Analysts' Estimates," *Insights*, Vol.12, No.7 (July 1998).

viewed as adopting such projections as the company's own.⁴⁶ The Third Circuit, for example, has most fully embraced the idea that comfort statements are actionable. *In re Burlington Coat Factories Securities Litigation*, the court explained:

To say that one is "comfortable" with an analyst's projection is to say that one adopts and endorses it as reasonable. When a high-ranking corporate officer explicitly expresses agreement with an outside forecast, that is close, if not the same, to the officer's making the forecast. We see no reason why adopting an analyst's forecast by reference should insulate an officer from liability where making the same forecast would not.⁴⁷

Our view is that direct statements of "comfort" with analysts' estimates need not be viewed as "litigation waiting to happen." On the contrary, trial courts are starting to accept the view that the Reform Act really *did* intend to impose a very high *scienter* standard in cases challenging forward-looking statements, whether based on explicit forecasts or expressions of "comfort." If the company carefully documents the objective evidence upon which its forward-

⁴⁶ Most of these cases differ from the so-called "entanglement" cases, where a company is alleged to be responsible for statements in an analyst' report on account of the company's involvement with the preparation of the report. The "entanglement" and "adoption" theories of liability are discussed in Section II.E, below.

⁴⁷ *In re Burlington Coat Factories Sec. Litig.*, 114 F.3d 1410, (3d. Cir. 1997). There is "no meaningful distinction between allegations of fraudulent statements which stand alone, *e.g.*, company official states that 'earnings will be at least \$5.00 per share' and those which derive their meaning from the adoption of the statements of others, *e.g.*, company states that "your predictions are accurate." *Schaffer v. Timberland*, 924 F. Supp. 1298 (D.N.H. 1996). In the court's view, "as a general matter, . . . statements of comfort with or . . . adoption or ratification of an analyst's projections may be actionable where the statements are sufficiently specific and accompanied by evidence suggesting that the defendants knew or should have known that the statement was false or misleading, *i.e.*, evidence of scienter."

looking statements are based, the company ultimately should prevail in a court action under the "actual knowledge" standard.⁴⁸

E. Reviewing, Approving And/Or Adopting Analyst Reports

1. The Pre-Publication "Entanglement" Theory

Companies frequently are asked to review an analyst's report prior to its release, which may give a corporation the opportunity to correct errors before they are made public and the chance to enhance relationships with analysts.⁴⁹ Despite such obvious benefits as increased accuracy, however, such review often has been viewed as extremely risky under pre-Reform Act case law. As the court in *Elkind v. Liggett & Myers, Inc.*⁵⁰ noted:

corporate pre-release review of the reports of analysts is a risky activity, fraught with danger A company which undertakes to correct errors in reports presented to it for review may find itself forced to choose between raising no objection to a statement which, because it is contradicted by internal information, may be misleading, and making that internal corporate information public at a time when corporate interests would best be served by confidentiality. Management thus risks sacrificing a measure of its autonomy by engaging in this type of program.⁵¹

⁴⁸ The insurance industry is now offering policies that make litigating such a case more cost-effective. In particular, under these new policies, the company may recover from the carrier *all* of its legal fees, including amounts paid out-of-pocket, if the company prevails on an early motion to terminate the case. This new policy form is intended to encourage more companies to defend themselves, rather than simply pay a large settlement.

⁴⁹ See Robert B. Robbins, "Informal Communications with Securities Analysts," *Insights*, Vol. 8, No. 4, at 10 (April 1994).

⁵⁰ 635 F.2d 156 (2d Cir. 1980).

⁵¹ *Id.* at 163-64.

This is the so-called "entanglement theory": a company that puts its implied or express imprimatur on an analyst's report prior to its publication is responsible for its accuracy, including predictive statements and any duty to update associated therewith.⁵²

a. *The "Bright Line" Rule*

Entanglement theory is not universally accepted outside the Ninth Circuit. In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,⁵³ the U.S. Supreme Court held that Congress did not intend to impose "aiding and abetting" liability when it enacted Section 10(b). Based on *Central Bank*, some courts have adopted a bright-line rule that, as one court summarized, "no matter how extensive a corporation's review and approval of statements in an analyst's report, that review and approval does not imply that the corporation, in effect, has

⁵² See generally Wander, Cope & Dariyanani, "Developments in Disclosure: Special Problems in Public Offerings — Forward-Looking Information, Including the Private Securities Litigation Reform Act of 1995," 33 *S.D. Law Rev.* 1027 (1996); see, e.g., *Leonard v. NetFrame*, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,982 (N.D. Cal. 1995); *In re Ross Systems, Inc.*, [1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,363 (N.D. Cal. 1994); *In re Network Equipment Technologies, Inc., Litigation*, 762 F. Supp. 1359 (N.D. Cal. 1991). In the last few years, a new form of "entanglement" litigation has arisen based on the theory that analysts and their firms have issued reports with inflated earnings forecasts and projections to bolster the standing of an otherwise feeble issuer's stock immediately following an IPO — an alleged practice that plaintiffs' lawyers euphemistically refer to as issuing "booster shots." See *Wander, supra*, at 1031; Jonathan C. Dickey, "The New 'Entanglement Theory,'" *Insights*, Vol. 9, No. 3, at 3 (March 1995).

In addition, the age of the world wide web has added additional perils. For example, some companies would not think twice about adding a hypertext "link" from the company's home page to a page with an analyst's report on the company. The SEC has recently addressed a similar issue with respect to posting a preliminary prospectus on the web along with hypertext links to research reports, and found that such an arrangement is not permissible. SEC Interpretive Release, 60 SEC Docket (CCH) 1100, at Example 16. Along these lines, *any* link to an analyst's report may increase the risk of adoption and entanglement. See H. Pitt & D. Johnson, *Avoiding Spiders on the Web: Rules of Thumb for Issuers Using Websites and E-Mail* at 5-6, Aug. 11, 1997 (unpublished manuscript).

⁵³ 511 U.S. 164 (1994).

'made' the statements in the analyst's report, for the purposes of liability under § 10(b).⁵⁴ As one court noted in adopting the bright-line rule:

[i]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).⁵⁵

Other courts, however, have not seen a conflict between *Central Bank* and the "entanglement" theory. These courts reason that, once a company becomes entangled, the statements in the analysts' reports become statements of the company itself: "*Elkind* held that a showing of entanglement could make an analysts' statements 'attributable' to a corporation as if those statements were a corporation's own, not that entanglement meant that the corporation had aided the analyst in making its statements."⁵⁶ In other words, entanglement is not a species of "aiding and abetting" liability at all — instead, it is "a claim of primary liability, pled on the theory that defendants used [the analyst] as their agent to make false or misleading statements to the market."⁵⁷

⁵⁴ *In re ICN/Viratek Sec. Litig.*, 1996 WL 164732 (S.D.N.Y. 1996) (criticizing cases and following *Elkind*); see also *In re MTC Electronic Technologies Shareholders Litig.*, 898 F. Supp. 974 (E.D.N.Y. 1995); *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D.Mass. 1994); *Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371 (E.D. Pa. 1994); *Walco Instruments Inc. v. Thenen*, 881 F. Supp. 1576, 1582 (S.D. Fla. 1995); *In re College Bound Consolidated Litig.*, 1994 WL 172408 (S.D.N.Y. 1994).

⁵⁵ *MTC Electronic Technologies*, 898 F. Supp. at 987.

⁵⁶ *ICN/Viratek*, 1996 WL 164732, at *6.

⁵⁷ *Id.*

b. *The "Two-Way Flow of Information" Rule*

In order for a company or its officers to be liable for misstatements in an analyst's report under the "entanglement" theory, (a) the officer must be sufficiently involved with the preparation of the report so that it is fair to attribute the information in the report to the company, and (b) the officer must have known that the information was false or unreasonable, yet have failed to disclose the falsity or unreasonableness to investors. Under the first prong, the Ninth Circuit — where many entanglement cases have been brought — "requires a 'two-way' flow of information between the corporate insider and the analyst preparing the challenged forecast."⁵⁸ In addition, under the second prong, the information in an analyst's forecast is presumptively reasonable unless there "was no reasonable basis for it at the time in which it was made."⁵⁹ That the forecast ultimately turned out to be incorrect is irrelevant.

Entanglement allegations are subject to heightened pleading requirements under Rule 9(b) of the Federal Rules of Civil Procedure. Courts that have explicitly discussed the issue have used various formulations for describing plaintiff's pleading burden. The most common approach is that taken by the Ninth Circuit, which requires that the plaintiff "(1) identify specific forecasts and name the insider who adopted them, (2) point to specific interactions between the insider and the analyst which gave rise to the entanglement; and (3) state the dates on which the acts which allegedly gave rise to the entanglement occurred."⁶⁰ Other courts, however, have declined to follow the three-part pleading requirement, and have used a more flexible

⁵⁸ *In re Syntex Corp. Sec. Lit.*, 855 F. Supp. 1086, 1096 (N.D. Cal. 1993), *aff'd*, 95 F.3d 922 (9th Cir. 1996).

⁵⁹ *See Caere Corp. Sec. Litig.*, 837 F. Supp. 1054, 1060 (N.D. Cal. 1993).

⁶⁰ *Id.* at 1059; *In re Syntex Corp.*, 855 F. Supp. at 1096.

formulation: "the court will determine whether the complaint contains allegations which, favorably construed and viewed in the context of the entire pleading, could establish a significant and specific, not merely a casual or speculative, entanglement between the defendants and the analysts with respect to the statements at issue."⁶¹

Whether a company can be said to have had sufficient involvement, and the requisite unreasonableness, is an issue as to which there is no national consensus or uniformity of case law. Showing that a company provided historical statistics, corrected factual inaccuracies or had internal forecasts contradictory to those in the analysts' forecasts should not constitute sufficient evidence to impose liability.⁶² As the court in *In re Caere Corp. Securities Litigation*, noted:

[i]n today's complex and highly competitive financial markets, countless analysts, investment managers, market makers and investment banking firms issue earnings and revenue forecasts on virtually every publicly-traded corporation. Forecasts may vary a great deal. If corporate insiders are held liable under Rule 10b-5 every time one of these forecasts proves to be incorrect, they would likely spend more time in court than running their companies.⁶³

Whether a company has been sufficiently involved in an analyst's report to put its "imprimatur" on the report is an elusive question. Courts have found insufficient involvement, and therefore granted motions to dismiss or for summary judgment to defendants, where:

⁶¹ *Schaffer v. Timberland Co.*, 924 F.Supp. 1298, 1310 (D.N.H. 1996) (citing *Gross v. Summa Four, Inc.*, 1995 WL 806823, at *26 (D.N.H. 1995)).

⁶² *Caere*, 837 F. Supp. at 1059-61.

⁶³ *Id.* at 1059.

- a company examined and commented on analysts' reports that contained misleading financial projections, but did not comment on the projections themselves. Because the company had a formal policy of not commenting on earnings forecasts, there was no entanglement;⁶⁴
- a company examined and commented on an early draft of an analyst's report, but failed to review the actual text of the final draft prior to issuance. The level of involvement was held not enough to show entanglement;⁶⁵
- plaintiff failed to show that corporate defendant departed from its "no-comment" policy regarding analysts' projections. There was no basis for entanglement liability;⁶⁶ and
- a corporation provided analysts with pricing and product information and discussed future manufacturing and marketing plans, but plaintiff made no showing that the corporation had reviewed reports or violated its internal policy of not commenting on analysts' forecasts. There was no finding of entanglement.⁶⁷

On the other hand, courts have also found sufficient evidence of entanglement where:

- a corporation reviewed an analyst's report the day before it issued and suggested certain changes. The analyst made the changes recommended by the corporation and issued the report without substantial further alterations. The corporation's motion for summary judgment on the entanglement claim was denied.⁶⁸
- a corporation made statements on conference calls with analysts regarding earnings, revenue and inventory levels. The analysts later incorporated these statements into their reports. Entanglement claims survived a motion to dismiss for failure to state a claim.⁶⁹

⁶⁴ *Id.*

⁶⁵ *SEC v. Wellshire Securities*, 773 F. Supp. 569, 573 (S.D.N.Y. 1991).

⁶⁶ *In re Seagate Technology II Sec. Litig.*, [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,530 (N.D. Cal. 1996).

⁶⁷ *In re Cypress Semiconductor Sec. Litig.*, 891 F. Supp. 1369, 1377 (N.D. Cal. 1995), *aff'd sub nom Eisenstadt v. Allen*, 113 F.3d 1240 (9th Cir. 1997).

⁶⁸ *In re ICN/Viratek Sec. Litig.*, 1996 WL 164732, at *7 (S.D.N.Y. 1996).

⁶⁹ *Schaffer v. Timberland Co.*, 924 F. Supp. 1298, 1321 (D.N.H. 1996).

- a corporation allegedly provided false information to analysts, approved drafts of analysts' reports, and circulated the reports to potential investors. Entanglement claims survived a motion to dismiss for failure to state a claim.⁷⁰

One lesson to be drawn from these cases is the importance that many courts place on having an official corporate policy of not commenting on projections, or at least saying that although the company may review a draft report, it does not comment on the earnings estimates. The existence of such a policy (particularly where it is publicly known, and therefore, clear to analysts themselves) provides strong evidence that a company reviewing an analyst's report has not communicated to the analyst that its projections are in line with the company's projections. Where a corporation has such a policy in place, it is fair to assume that plaintiff's burden is a higher one — plaintiff must prove that the corporation violated its own policies.

Another lesson to be drawn from the case law is that it should not be actionable misconduct for a company merely to comment on whether the analysts' assumptions are correct, without commenting directly on the analysts' projections. In our view, a company should be able to comment to an analyst that he or she has made a faulty assumption about the company's business or operations. Invariably, such a comment will cause the analyst to reconsider his or her projections in the process, without the company's comment on the projections directly.

Yet another lesson is that very little in a company's communications with the street is "off the record." Whether the company does so or not, the analysts frequently keep notes and other records of their conversations, all of which may be discoverable. *If* guidance is to be given, companies should assume that their statements are "on the record," and, accordingly, they should

⁷⁰ *In re RasterOps Corp. Sec. Litig.*, 1994 WL 618971 (N.D. Cal. 1994).

have reasonable factual corroboration for any positive guidance given, in order to prove later that the statements were not made with "actual knowledge" of their falsity.

2. Post Publication "Adoption" of Analyst Reports

In contrast to traditional "entanglement" liability, *In re Presstek, Inc.*,⁷¹ the SEC stated that a company can become liable for misstatements in an analyst's report by "adopting" the contents of the report after publication. Both forms of liability rest on a theory of implied representation by the company. Entanglement involves an implied representation *to the analyst* preparing the report. Once entangled, the analyst becomes the company's agent in distributing the information contained in the report. Post-publication adoption, on the other hand, involves a company's implied representation *to the market* that the information in the report is accurate.

The facts in *Presstek* are instructive. On December 22, 1997, both the Chairman and the President of Presstek, Inc., a New Hampshire based manufacturer of printing press technology and related products, consented to entry of a final judgment against them that included a permanent injunction and the payment of \$2.9 million in civil penalties. Among other things, the company had distributed a series of analysts' reports that the company knew or had reason to know greatly overestimated earnings and product sales levels. Two reports issued in April 1994, for example, estimated 1995 earnings of \$1.00 and \$1.10 per share, respectively. Both projections greatly exceeded the company's internal projections. A January 1995 report stated that earnings per share from a specific product would be \$0.90 once the "first 100 machines" that used company technology were in the field; internal projections, in contrast, estimated earnings per share at \$0.23. Despite this, the company included the reports in its investor packets and in mailings to the

⁷¹ *In re Presstek, Inc.*, SEC Exchange Act Release No. 39,472 (Dec. 22, 1977).

company mailing list. In addition, a November 1995 report included forecasts for 1996 greatly exceeding the company's forecasts. The company distributed this report for over six months, often in response to outsiders' requests for earnings forecasts. It also distributed the report to attendees at its annual shareholders meeting.

The SEC's distinction between "entanglement" and "adoption" stems from a series of opinions written by former Judge Aguilar on the U.S. District Court for the Northern District of California.⁷² Those cases establish "adoption" as a source of liability distinct from "entanglement":

In addition to engaging in pre-publication entanglement activity, a corporation may ratify analysts' reports after they have been published. This occurs when a company conveys the suggestion that the analysts' forecasts are accurate or at least in accordance with its views. Distributing analysts' reports to potential investors may, depending on the circumstances, amount to an implied representation that the reports are accurate.⁷³

Distribution to the market is the key concept in adoption liability. Although a single conversation with an analyst might "entangle" a company in the analyst's report, arguably something needs to be done on a larger scale for "adoption" liability. Case law suggests that a company can distribute reports without adoption liability if the distribution is selective enough and if news of the distribution does not reach the market. Defendants in *In re Cypress Semiconductor Securities Litigation*, for example, distributed analysts' reports to two shareholders. Their summary judgment motion against an adoption claim based on the "fraud on the market" theory succeeded because there was no evidence that news of Cypress' endorsement

⁷² See *In re Cypress Semiconductor Sec. Litig.*, 891 F. Supp. 1369 (N.D. Cal. 1995); *Strassman v. Fresh Choice, Inc.*, 1995 WL 743728 (N.D. Cal. Dec. 7, 1995); *In re RasterOps Corporation Sec. Litig.*, 1994 WL 618970 (N.D. Cal. Oct. 31, 1994).

⁷³ *Cypress Semiconductor*, 891 F. Supp. at 1377.

was made public: "There were no mass mailings and no evidence that the marketplace was informed of Cypress' actions."⁷⁴ One wonders, however, how the same court might view a situation in which a company provides on its website a summary of the "street consensus" on revenue and earnings. Arguably, such a posting comes close to the type of wide-spread dissemination and endorsement that would trigger "adoption" of those research reports.

Although the limited adoption case law does not discuss the effectiveness of disclaimers accompanying the distribution of analysts' reports, *Presstek* implies that a disclaimer may work to shield liability to some extent. In the words of the SEC, the company in *Presstek* distributed the reports "without any disclaimer, thus putting the company's imprimatur on the report."⁷⁵ The SEC's opinion does not, however, give any guidance on what kind of disclaimer would be effective, nor how the disclaimer would work. In our view, at least in the Ninth Circuit, a simple disclaimer that "the information in the report was not prepared or reviewed by the company" accompanying an analyst report widely disseminated to shareholders may *not* be sufficient to block "adoption" liability. However, a disclaimer on the company's website accompanying contact names and phone numbers of analysts providing coverage on the company *may* be sufficient.

3. Recent Cases in the Ninth Circuit

Although not exhaustive, the following list of cases provides a representative sampling of recent "entanglement" and "adoption" decisions, and reflects continuing confusion and inconsistency among trial courts within the Ninth Circuit.

⁷⁴ *Id.*

⁷⁵ See *Presstek*, SEC Exchange Act Release No. 39,472, at 7, 11.

a. *Eisenstadt v. Allen* (Ninth Circuit 1997)⁷⁶

In this pre-Reform Act decision involving Cypress Semiconductor, the Ninth Circuit elaborately analyzed Cypress' potential liability for statements allegedly made in newspaper articles and analyst reports. Reviewing the grant of a summary judgment motion, the Ninth Circuit panel affirmed summary judgment entirely on procedural grounds, finding the alleged false statements made by Cypress directly to analysts all were inadmissible hearsay. As to statements the company allegedly made in analyst conference calls, the Ninth Circuit found no evidence to support the claim that management did not believe the statements when made, or that management lacked a reasonable basis for making the statements. With respect to any alleged adoption or entanglement, the Ninth Circuit reiterated the *Syntex* "imprimatur" standard,⁷⁷ and affirmed summary judgment based on the absence of evidence of entanglement. In this regard, although plaintiffs had produced copies of research reports faxed to Cypress executives, the record indicated they were faxed after the date of their issuance. There was no evidence that Cypress communicated with the analysts after publication, let alone approved them beforehand. Cypress witnesses testified that Cypress had an express policy prohibiting officers from commenting on analyst projections. Although there was evidence that Cypress representatives may have spoken with analysts in the context of conference calls and sometimes outside that context, this demonstrated only a one way flow of information, involving only factual and historical information (despite a quote from Cypress' CEO that he would "work with you to develop numbers over the next few weeks to get your estimates accurate," which the court said

⁷⁶ 113 F.3d 1240 (9th Cir. 1997).

⁷⁷ *In re Syntex Corp. Sec. Litig.*, 855 F. Supp. 1086, 1096 (N.D. Cal. 1993), *aff'd*, 95 F.3d 922 (9th Cir. 1996).

merely referred to getting the analysts accurate historical information on several recent investments Cypress had made).

It should be noted that in rejecting plaintiffs' adoption and entanglement claims, the Ninth Circuit in *Eisenstadt* repeats the same fuzzy thinking as is present in several pre- and post-Reform Act district court decisions, namely, that to hold a corporation liable for an analyst's predictions, plaintiff "must demonstrate that a corporate insider provided misleading information to an analyst" The Ninth Circuit again confuses the cause of action for "direct" liability for making a false statement and the cause of action for "adoption" or "entanglement."

b. *Genna v. Digital Link* (N.D. Cal. 1997)⁷⁸

This Reform Act case found that the issuer had sufficiently entangled itself in analyst reports, based on the presence of allegations of (a) specific dates of reports, (b) the substance of the reports, (c) that the analyst had "met with, interviewed and/or obtained the key information for the report from Digital Link executives," and (d) that "Digital Link approved the information in this report before it was issued." However, the court found that plaintiffs had failed to allege that the defendants *knew* that the analysts' forecasts were unreasonable when they were issued, finding that an analyst's forecast is unreasonable only if there was *no reasonable basis* for it at the time it was made.⁷⁹

As discussed in Section II.A above, the language in the *Digital Link* decision concerning when an analyst forecast will be deemed "unreasonable" appears to have its roots in pre-Reform Act case law, which in turn is based upon pre-Reform Act concepts of when a forward-looking

⁷⁸ 25 F. Supp. 2d 1032 (N.D. Cal. 1997).

⁷⁹ *Id.* at 1039 (citing *Caere Corp.*, 837 F. Supp. at 1060).

statement generally is actionable. In this regard, *Digital Link, Caere* and similar cases can be said to derive from the "no reasonable basis" standard under the SEC's Rule 175 under the 1933 Act, which arguably should not apply to Reform Act cases alleging "entanglement" or "adoption." Instead, an "actual knowledge" standard should apply.

c. ***In re Oak Technology Securities Litigation* (N.D. Cal. 1997)**⁸⁰

This Reform Act case involved claims against both the company and the underwriting firm that issued the analyst reports in dispute. The court dismissed the claims against the company without discussing the analyst reports. As to the claims against the underwriter, the court found that the research reports were intended for the underwriting firm's clients, and that the underwriter did not owe a legal duty to non clients to disclose material adverse facts.⁸¹ As for any alleged misrepresentations, the court found that plaintiffs failed to allege any internal documents or other contemporaneous facts indicating that the underwriter "did not believe its projections."⁸² Although the court offered no discussion or analysis of the *scienter* standard, the "did not believe" standard obviously comes closer to the "actual knowledge" standard that would apply under the Reform Act if the analyst report were deemed to be published "on behalf of" the issuer.

⁸⁰ 1997 WL 448168 (N.D. Cal. Aug. 1, 1997).

⁸¹ *Id.* at *13 (citing *In re Valence Technology Sec. Litig.*, 1996 WL 3378, at *9 (N.D. Cal. Jan. 23, 1996)).

⁸² *Id.* at *14.

d. *Powers v. Eichen* (S.D. Cal. 1997)⁸³

This Reform Act case concerning Proxima Corporation, purporting to follow the Ninth Circuit's decision in *Syntex*, stated that the company could be liable if it "fostered and reviewed but failed to correct" analyst forecasts, *if* the company "expressly or impliedly represented that the information was accurate or coincided with the company's views."⁸⁴ This language both broadens and confuses the *Syntex* standard, as it appears to mix up the standards for entanglement and adoption ("fostering" a report, being a seemingly different act than "reviewing" it, and imposing a "duty to correct" in either case). Further evidencing the court's confusion is its finding that to prove adoption, the plaintiff must show "that the insider provided misleading information to an analyst"⁸⁵ In fact, the adoption theory does not require any proof that the issuer proved false information, only that the issuer embraced the analysts' projections as its own (see discussion above regarding the *Eisenstadt* case). Nevertheless, the court found that plaintiffs in that case had only alleged a "one way flow of information" rather than acts of endorsement or approval.

e. *In re Opti Securities Litigation* (N.D. Cal. 1997)

This unpublished Reform Act case followed *Syntex* and held that plaintiffs failed to allege that defendants had put their "imprimatur, express or implied," on the analyst projections. The decision mentions the concepts of both adoption and entanglement, but does not separately analyze them. The court noted that there were allegations that defendants had received copies of

⁸³ 977 F. Supp. 1031 (S.D. Cal 1997).

⁸⁴ *Id.* at 1042.

⁸⁵ *Id.*

the analyst reports, but no other facts demonstrated entanglement. The court also found that the allegations of misleading information allegedly provided to the analysts were too vague to show that Opti "intentionally" used the analysts to disseminate false information, and that plaintiffs' complaint allegations failed to demonstrate that defendants "knew the statements were false when made." This language seems to track with the Reform Act pleading standard, although there is no direct discussion of the Reform Act as it relates to liability for analyst statements.

f. *Plevy v. Haggerty* (C.D. Cal. 1998)⁸⁶

This Reform Act case against Western Digital involved a number of analyst statements, and allegations that management said they were "comfortable" with the analyst's forecasts. The court followed *Syntex* and held that the analyst reports "were the culmination of a one-way flow of information, from the company's representatives to analysts"⁸⁷ Although the court said it was "debatable" whether expressing "comfort" with a forecast was sufficient to have placed the company's imprimatur on the projection, the court did not reach this issue since it also found that the analysts' estimates turned out not to be false, as the company met or exceeded those estimates in each case.⁸⁸ Finally, the court found insufficient allegations of any specific false information the company had provided to analysts, and that "plaintiffs cannot assume that the analysts' reports simply repeated verbatim the statements made to them by defendants."⁸⁹

⁸⁶ 38 F. Supp. 2d 816 (C.D. Cal. 1998).

⁸⁷ *Id.* at 823-24.

⁸⁸ *Id.* at 824.

⁸⁹ *Id.*

g. ***Ronconi v. Larkin* (N.D. Cal. 1998)**⁹⁰

This Reform Act case against Nellcor Incorporated alleged that the company's CFO had spoken with analysts and given false information that sales of the company's principal product were up, and that the company's merger with another company would go smoothly and result in "leveraged earnings per share growth" over subsequent years. The CFO also said he was "comfortable" with analysts' estimates.⁹¹ Without discussing Reform Act pleading standards, other than to acknowledge that they can apply to pre-Reform Act statements, the court held that the allegations were insufficient under the Ninth Circuit's *en banc* opinion *In re GlenFed, Inc. Securities Litigation*,⁹² and distinguished the pre-Reform Act decisions in *Fecht v. Price Co.*,⁹³ *Warshaw v. Xoma*,⁹⁴ and *Cooper v. Pickett*. The court stated instead that "It is not enough simply to allege that the statements were false. Nor is the falsity established by an allegation that the opposite was true. And falsity is not established by an allegation that the statement was false because it did not later come true."⁹⁵

⁹⁰ 1998 WL 230987 (N.D. Cal. May 1, 1998).

⁹¹ *Id.* at *2-3.

⁹² 42 F.3d 1541 (9th Cir. 1994).

⁹³ 70 F.3d 1078, 1082 (9th Cir. 1995), *cert. denied*, 517 U.S. 1136 (1996).

⁹⁴ 74 F.3d 955 (9th Cir. 1995).

⁹⁵ 1998 WL 230987, at *7.

h. *Rubin v. Trimble* (N.D. Cal. 1997)⁹⁶

This pre-Reform Act case involving Trimble Navigation held inactionable statements made in analyst conference calls that Trimble was "confident" that it would achieve a defined figure of earnings per share growth in the following year. Plaintiffs had alleged that defendants knew at the time these statements were made that it was suffering a slowdown in its main line of business.⁹⁷ However, the court found that there were no facts pleaded to show that the forecast still could not have been met, even assuming the adverse facts were then known to management. The court concluded, "plaintiffs essentially allege that defendants should have done a better job of forecasting, based on the information then known. This is not fraud."⁹⁸

i. *In re Stratosphere Corp. Securities Litigation* (D. Nev. 1998)⁹⁹

This Reform Act case cited *Syntex* in holding that, as to most of the allegations of entanglement, plaintiffs had alleged only a one way flow of information, although the complaint expressly alleged that an officer of Stratosphere had "reviewed drafts of analysts' reports, provided comments on them, and discussed such reports with the analysts prior to their issuance"¹⁰⁰ The court found that all plaintiffs had alleged was that defendants had provided information to the analysts on which their reports were based.¹⁰¹ As to a few analyst

⁹⁶ 1997 WL 227956 (N.D. Cal. Apr. 28, 1997).

⁹⁷ *Id.* at *2-4.

⁹⁸ *Id.* at *15.

⁹⁹ 1 F. Supp. 2d 1096 (D. Nev. 1998).

¹⁰⁰ *Id.* at 1115.

¹⁰¹ *Id.*

reports, the court allowed the claims, where it was alleged that an officer had approved the reports in response to faxes from the particular analysts, and had sent them drafts of reports back to them prior to their issuance.¹⁰² Also, the court upheld allegations that the company had distributed copies of the reports and/or provided a list of analysts' coverage in the package that Stratosphere sent to potential investors.¹⁰³ As to the allegations that Stratosphere had directly provided false information to the analysts, the court held that plaintiffs had failed to allege the time place and content of any specific false statement, and therefore there was no additional liability under *Cooper v. Pickett*.¹⁰⁴

j. *Wenger v. Lumisys* (N.D. Cal. 1998)¹⁰⁵

This Reform Act case involved extensive allegations of misrepresentations and omissions in connection with analyst conference calls, research reports, and the like. The court held that plaintiff had failed to show that Lumisys had provided any false or misleading information to analysts, and therefore had no claim for direct liability under *Cooper v. Pickett*.¹⁰⁶ As to entanglement, the court held that a defendant is sufficiently entangled when he has reviewed the analyst forecasts, "and by his activity made an implied representation that the information is true or at least in accordance with the company's views."¹⁰⁷ Also, plaintiffs must point to specific

¹⁰² *Id.* at 1115-16.

¹⁰³ *Id.* at 1116.

¹⁰⁴ *Id.* at 1115.

¹⁰⁵ 2 F. Supp. 2d 1231 (N.D. Cal. 1998).

¹⁰⁶ *Id.* at 1249.

¹⁰⁷ *Id.* (citing *Caere Corp.*, 837 F. Supp. at 1059).

interactions between the insider and the analyst which gave rise to the entanglement. In this case, plaintiffs expressly alleged that officers of Lumisys had spoken with the analysts, who had relied upon and utilized information provided to them, and thereafter Lumisys copied the reports and distributed them, "thus endorsing them and adopting them as its own."¹⁰⁸ The court found these allegations insufficient, and failed to show how Lumisys had distributed the reports or that Lumisys "approved" the reports before they were issued.¹⁰⁹ This holding obviously sets a very high bar, particularly in light of the pleading standard set forth elsewhere in the opinion that it was enough to allege that there was an "implied" representation that the analyst report is in accordance with the company's views.¹¹⁰ Again, there appears to be a confusion of adoption and entanglement concepts at work in this decision.

It is also noteworthy that the court also held that plaintiffs failed to allege that defendants "knew that the analysts' forecasts were *unreasonable* when they were issued."¹¹¹ The court observed that an analyst report is unreasonable "only if there is no reasonable basis for it"¹¹² This language arguably mixes two different *scienter* standards, one involving intentional conduct and one involving negligent conduct. As in other recent decisions, the court here carries forward some of the pre-Reform Act case law that used the "reasonable basis" standard of SEC Rule 175.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 1249-50.

¹¹⁰ *Id.*

¹¹¹ *Id.* at 1249-50.

¹¹² *Id.* at 1250.

k. *In re Yes! Entertainment Corp. Securities Litigation* (N.D. Cal. 1998)

This Reform Act case briefly cites to *Syntex* and *Cooper v. Pickett*, and dismisses claims alleging entanglement and direct liability for making false statements to analysts. The court impliedly held that a claim may be based upon false statements made by the company to securities analysts under *Cooper*, and also for entanglement if the company put its imprimatur, "express or implied," on the analyst projections.¹¹³

l. *Zeid v. Kimberley* (N.D. Cal. 1997)¹¹⁴

This Reform Act case alleged that Firefox Communications gave misleading information to analysts, and that Firefox executives reviewed and approved some but not all of the draft analyst reports "and assured the analysts that the reports were correct."¹¹⁵ Citing *Syntex*, the court held these allegations insufficient to sustain claims of entanglement as to all but two of the reports.¹¹⁶ The court also found that most of the alleged misleading statements in the reports were too vague, or never reached the market.¹¹⁷ The court also distinguished between statements that might have been based on information from the company, versus statements that clearly were expressed as the opinions of the analyst, and therefore not attributable to the

¹¹³ Slip opinion at 1-2 (N.D. Cal. May 15, 1998).

¹¹⁴ 973 F. Supp. 910 (N.D. Cal 1997).

¹¹⁵ *Id.* at 919.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

company.¹¹⁸ The court did not even reach the *scienter* issue, finding that plaintiffs simply failed to plead any false statement that could properly be attributed to the company.

m. *Molinari v. Symantec Corp.* (N.D. Cal. 1998)¹¹⁹

This Reform Act case against Symantec Corp. upheld claims based on an adoption theory. In a brief discussion of the issue, the court noted that defendants had argued that the complaint failed to allege any statements in the research reports attributable to Symantec. The court confusingly found that "plaintiffs clarify that they seek to hold defendants [liable] for allegedly fraudulent statements made directly to analysts, not for statements issued by analysts to the public. Therefore the plaintiffs need not allege adoption"¹²⁰ This decision obviously fails to discuss the fact that if the statements in question never reached the market, they should not be actionable under the "fraud on the market" theory.

n. *Head v. Netmanage* (N.D. Cal. 1998)

This unpublished Reform Act case turned in part on allegations of entanglement. The court, citing the Ninth Circuit's pre-Reform Act decision in *Syntex*, held that plaintiffs had failed to plead that defendants had placed their "imprimatur, express or implied, on the projections." The court noted that plaintiffs had failed to identify who spoke to the analyst, and when, who previewed the analyst report and when, and what investor relations packet the analysts' report was distributed and when.

¹¹⁸ *Id.* at 920.

¹¹⁹ 1998 WL 78120 (N.D. Cal. Feb. 17, 1998).

¹²⁰ *Id.* at *8 (citing *Cooper v. Pickett*).

o. *In re Silicon Graphics Securities Litigation* (N.D. Cal. 1997)¹²¹

In this Reform Act case, the court upheld the pleading sufficiency of various statements made by Silicon Graphics ("SGI") executives in analyst conference calls and presentations at analyst conferences. As to liability for one-on-one communications with analysts, the court found it sufficient that plaintiffs had alleged that two particular SGI officers had made allegedly false and misleading statements to two analysts "in the few days prior to December 19, 1995."¹²² Citing pre-Reform Act case law, the court held that plaintiffs satisfy their pleading burden under Rule 9(b) simply by alleging a false or misleading statement, together with who communicated with the analysts, and the time and place such communications occurred.¹²³ The court thus made no attempt to apply traditional "entanglement" or "adoption" analyses. As has been well publicized, the court dismissed the case on other grounds, and in particular the failure to allege *scienter* under the Reform Act with the requisite particularity. Ironically, while the court imposed perhaps one of the highest pleading standards under Reform Act case law on the *scienter* issue, the court did not impose very stringent standards for alleging potential liability for false statements to analysts. The Ninth Circuit ultimately upheld the district court's ruling on the *scienter* issue, but did not address questions arising from the defendants' communications with analysts.¹²⁴

¹²¹ 970 F. Supp. 746 (N.D. Cal. 1997).

¹²² *Id.* at 764.

¹²³ *Id.*

¹²⁴ 183 F.3d 970 (9th Cir. 1999).

p. *In re Cirrus Logic Securities Litigation* (N.D. Cal. 1996)¹²⁵

This pre-Reform Act case, decided on summary judgment, reviewed statements in thirty-two analyst reports, and other statements made to analysts. The court found no evidence supporting an entanglement theory, noting instead that four out of six analysts testified that Cirrus had not reviewed or approved their analyst reports, and all who were deposed had relied on sources of information other than Cirrus.¹²⁶ Cirrus had an internal policy allowing only certain company representatives to speak with analysts each of whom testified that they never commented on analysts' projections and never provided the company's internal forecasts or other financial guidance.¹²⁷ The court similarly rejected plaintiffs' adoption theory, explaining that the fact that Cirrus kept track of analysts' estimates and "published" those estimates was insufficient evidence of adoption.¹²⁸

With respect to liability for Cirrus statements made *to* analysts, the court rejected defendants' contention that they could only be liable if they adopted or were entangled with the research reports themselves. Citing *Warshaw v. Xoma*,¹²⁹ the court held that defendants could be liable for making misleading statements to analysts, so long as the statements reach the market. On this issue, the court found that plaintiffs bear the burden to show that the statement

¹²⁵ 946 F. Supp. 1446 (N.D. Cal. 1996).

¹²⁶ *Id.* at 1466.

¹²⁷ *Id.*

¹²⁸ *Id.* (citing *Seagate Technology II Sec. Litig.*, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 98,530, at 91,583 (N.D. Cal. 1995)).

¹²⁹ 74 F.3d 955, 959 (9th Cir. 1996).

in fact reached the market.¹³⁰ Analyst conference calls meet that test, but private phone calls do not. The court rejected evidence in the form of an analyst's handwritten notes of private discussions with management, on the grounds that the notes were inadmissible hearsay. The court held that if plaintiffs could find corroborating evidence that Cirrus made the statements to the analyst, that evidence might support the conclusion that Cirrus made the statements and that the analyst thereafter repeated them to the market.¹³¹

q. *In re Valence Technology Securities Litigation* (N.D. Cal. 1996)¹³²

In this pre-Reform Act case, underwriters of Valence's public offering moved to dismiss claims based on their analyst reports. The court held, *inter alia*, that because the complaint alleged that the analysts relied on statements and information made to them by Valence, who allegedly assured them that the reports were accurate, the reports by definition had a reasonable basis.¹³³ Further, the court found that the named plaintiffs were not clients of the underwriters, had not read or relied upon the analyst reports themselves, and the reports had not been issued to the general public. Therefore, the underwriters owed no legal duty to the class, and the claims based on the research reports were dismissed without leave to amend.¹³⁴

¹³⁰ *Cirrus Logic*, 946 F. Supp. at 1467-68.

¹³¹ *Id.* at 1468.

¹³² 1996 WL 37788 (N.D. Cal. Jan. 23, 1996), *rev'd on other grounds*, 175 F.3d 699 (9th Cir. 1999).

¹³³ *Id.* at *7-8.

¹³⁴ *Id.* at *9.

r. *In re Sybase , Inc. Securities Litigation* (N.D. Cal. 1999)¹³⁵

In this pre-Reform Act case, the court found that plaintiffs had produced sufficient corroborating evidence that Sybase had given "comfort" with respect to street earnings estimates of \$1.85 per share for 1995.¹³⁶ However, the court granted summary judgment after reviewing Sybase's "elaborate" forecasting process and concluding that management relied in good faith upon a particular internal forecast that was consistent with the "comfort" given to the street.¹³⁷

F. Impact Of Disclosures To Analysts On Periodic SEC Filings

Disclosures to analysts and the financial press may also impact an issuer's filing requirements under the Securities Act and the Exchange Act. A press release which is inconsistent with a Exchange Act filing (*i.e.*, Form 10-K or Form 10-Q) may raise questions as to whether these filings are accurate or complete; an issuer needs to be careful that any material information which is disclosed to the market, either through press releases or unrecorded conversations with analysts, be also reflected in the next applicable Exchange Act SEC filings or Securities Act prospectus, or that a filing be made or amended to reflect such disclosures.

In *In re Shared Medical Systems*,¹³⁸ the SEC brought an administrative cease and desist proceeding against the defendant for failing to disclose in its Form 10-K for the year ended December 31, 1986 (which was filed on March 23, 1987) and in its Form 10-Q for the quarter ended March 31, 1987, that revenues and earnings for the end of 1986 and the beginning of 1987

¹³⁵ 48 F. Supp. 2d 958 (N.D. Cal. 1999).

¹³⁶ *Id.* at 961.

¹³⁷ *Id.* at 962.

¹³⁸ SEC Exchange Act Release No. 33,632, 56 SEC Docket 199 (Feb. 17, 1994).

would be down. This information was, however, contained in a February 17, 1987 press release. The SEC, noting that issuers have a duty to "file annual and quarterly reports . . . and to keep this information current," found that the corporation had violated this duty by failing to disclose information which it obviously had, as evidenced by the press release. This case highlights the need for corporations to be sure that informal disclosures made to financial analysts or the press are consistent with SEC filings and other more formal releases of potentially material information.

III. THE SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS

A. Background

1. Initial SEC Attempts to Encourage Publication of Forward-Looking Statements

In 1979, the SEC promulgated Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act, creating safe harbor protection for certain specific forward-looking statements, such as earnings forecasts. These rules, which applied only to statements made, reaffirmed or later published in documents filed with the SEC, added additional pleading and proof burdens, and shielded defendants from securities claims where the forward-looking statements were made in good faith and with a reasonable basis. Although the issuer was not required to state the assumptions underlying the covered statements, the assumptions, if stated, also would fall within the scope of the safe harbor.¹³⁹ Nevertheless, issuers were reluctant to take advantage of the safe harbor, and the rules did not spur the quantity or quality of forward-looking disclosures that the SEC had desired.

¹³⁹ See SEC Securities Act Release No. 33-6084, 44 F.R. 33810 (June 25, 1979).

2. The "Bespeaks Caution" Doctrine

The judicially-created "bespeaks caution" doctrine provided issuers with additional protection against securities claims based on allegedly false and misleading forward-looking statements. The doctrine holds that certain types of predictions may be rendered immaterial as a matter of law if accompanied by appropriately specific cautionary language. As articulated by the Ninth Circuit in 1994, "the doctrine, when properly construed, merely represents the pragmatic application of two fundamental concepts in the law of securities fraud: materiality and reliance."¹⁴⁰ The doctrine has enjoyed widespread acceptance in the courts.¹⁴¹

Although courts have not hesitated in accepting the "bespeaks caution" doctrine, they have differed in the extent to which they take into account the defendant's good faith or reasonable belief in the truth of the statement. Thus, for example, the Third Circuit in *In re Donald J. Trump Casino Securities Litigation*, affirmed the District Court's dismissal of an action based on the "abundant and meaningful cautionary language contained in the prospectus."¹⁴²

¹⁴⁰ *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1414 (9th Cir. 1994), *cert. denied*, 116 S. Ct. 185 and 116 S. Ct. 277 (1995); *In re Boeing Sec. Litig.*, 40 F. Supp. 2d 1160 (W.D. Wash. 1998).

¹⁴¹ *See, e.g., Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 548 (8th Cir. 1997); *Grossman v. Novell*, 120 F.3d 1112, 1121 (10th Cir. 1997); *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 5 (2d Cir. 1996); *Rubenstein v. Collins*, 20 F.3d 160, 166-68 (5th Cir. 1994); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 364, 371-73 (3d Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994); *Romani v. Shearson Lehman Oppenheimer & Co., Inc.*, 929 F.2d 875, 879 (1st Cir. 1991); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040-41 (6th Cir. 1991); *Rhodes v. Omega Research, Inc.*, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,451, at 92,092-93 (S.D. Fla. 1999).

¹⁴² 7 F.3d at 372; *see also, Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1033 (2d Cir. 1993) (holding that an investor's recklessness may preclude recovery for false and misleading

In contrast, the Sixth Circuit in *Mayer v. Mylod*,¹⁴³ held that securities claims should not have been dismissed based solely on the presence of cautionary statements because "[m]aterial statements which contain the speaker's opinion are actionable under Section 10(b) of the . . . Exchange Act if the speaker does not reasonably believe the opinion and the opinion is not factually well grounded."¹⁴⁴

There was also some discrepancy as to how closely the cautionary language must correlate to the challenged forward-looking statement in order to "bespeak caution." Some courts required that the cautionary statements be "substantive and tailored to the specific future projections, estimates or opinions" challenged by plaintiffs.¹⁴⁵ Others took a much broader view, going so far as to hold that cautionary statements in one document may shield forward-looking statements in other documents.¹⁴⁶ The Ninth Circuit has drawn a distinction between the "bespeaks caution" doctrine and the "truth-on-the-market" defense, noting that truth-on-the-market requires the disclosed information to have entered the market in such a way as to

[Footnote continued from previous page]

statements and declining to impose liability for allegedly false and misleading oral statements where prospectus and partnership brochure disclosed the risks of the venture).

¹⁴³ 988 F.2d 635 (6th Cir. 1993).

¹⁴⁴ *Id.* at 649-41; *see also Rubenstein v. Collins*, 20 F.3d 160, 168 (5th Cir. 1994) ("The appropriate inquiry is whether, under all the circumstances, the omitted fact or the prediction without a reasonable basis 'is one [that] a reasonable investor would consider significant in [making] the decision to invest, such that it alters the total mix of information available about the proposed investment'"); *Havsy v. Just Toys, Inc.*, 1994 WL 381447, at *3 (S.D.N.Y. Jul. 20, 1994) (asserting that the bespeaks caution doctrine "insulates good-faith projections from liability").

¹⁴⁵ *E.g., Kline v. First Western Government Securities, Inc.*, 24 F.3d 480, 489 (3d Cir.), *cert. denied*, 513 U.S. 1032 (1994).

¹⁴⁶ *E.g., Grossman*, 120 F.3d at 1121.

"counterbalance" the alleged misstatements, whereas the "bespeaks caution" doctrine focuses on whether cautionary language in a *particular document* is sufficient to render the "total mix of information" not misleading.¹⁴⁷

B. The Statutory Safe Harbor Under The Reform Act

In an attempt to encourage companies to disclose projections and other "soft" information, and to impose some uniformity of expectations, Congress included as part of the Reform Act a statutory "safe harbor" for certain forward-looking statements. It was hoped that, by reducing the threat of liability, Congress could increase the quantity and quality of forward-looking information disseminated to investors.¹⁴⁸

The "safe harbor" codifies parts of the "bespeaks caution" doctrine,¹⁴⁹ and immunizes forward-looking statements that are "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially"¹⁵⁰ Under the safe harbor, oral statements may also qualify for protection if they (a) identify the statement as forward-looking; (b) state that actual results could differ materially; and (c) identify a "readily

¹⁴⁷ See *Provenz v. Miller*, 102 F.3d 1478, 1492-93 (9th Cir. 1996); see also *In re Sybase Sec. Litig.*, 48 F. Supp. 2d 958 (N.D. Cal. 1999) (applying truth on the market defense, court grants summary judgment in light of fact that Sybase product issues were "amply reported by industry analysts in numerous publications").

¹⁴⁸ See H.R. Rep. No. 105-369, 104th Cong., 1st Sess. at 43 (Joint Explanatory Statement Of The Committee Of Conference) (Nov. 28, 1995).

¹⁴⁹ *Id.*

¹⁵⁰ See 15 U.S.C. § 78u-5(c)(1)(A)(i).

available" written document containing additional factors that could cause results to differ materially from the forward-looking statement.¹⁵¹

Significantly, the "safe harbor" expressly disclaims imposing any duty to update any forward-looking statements.¹⁵² There may, however, be a duty to update if a statement's terms imply continuing validity, but subsequent events render the initial statement false or materially misleading.¹⁵³

C. Judicial Interpretations

1. "Meaningful Cautionary Statements"

Courts applying the statutory safe harbor have indicated that a company need not identify "all" factors that might affect the validity of a projection, as long as it discloses *some* of them.¹⁵⁴ Numerous courts have applied the safe harbor to dismiss claims based on allegedly false or misleading forward-looking statements.¹⁵⁵

However, as was true under the judicially created "bespeaks caution" doctrine, general "boilerplate" warnings will not suffice to immunize a forward-looking statement. Thus, in

¹⁵¹ 15 U.S.C. § 78u-5(b)(2).

¹⁵² 15 U.S.C. § 78u-5(d).

¹⁵³ See, e.g., *Backman v. Polaroid Corp.*, 910 F.2d 10, 17 (1st Cir. 1990) (*en banc*).

¹⁵⁴ See, e.g., *Rasheedi v. Cree Research, Inc.*, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,566, at 97,818 (M.D.N.C. 1997).

¹⁵⁵ See, e.g., *P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp.*, 1999 WL 254467 (D.N.J. Apr. 30, 1999); *Karcand v. Edwards, et al.*, 53 F. Supp. 2d 1236 (D. Utah 1999) (holding that disclosures in company's SEC filings and press releases bespoke caution); *EP Medsystems, Inc. v. Echocath, Inc.*, 30 F. Supp. 2d 726 (D.N.J. 1998) (holding that cautionary statements in offering documents rendered oral misrepresentations immaterial); *Plevy v. Haggerty*, 38 F. Supp. 2d 816 (C.D. Cal. 1998) (applying "bespeaks caution" doctrine to dismiss claims in a Reform Act case).

several Reform Act cases, trial courts have denied motions to dismiss, finding that the cautionary statements were not sufficiently particular.¹⁵⁶

Although misstatements of historical fact are not protected by the safe harbor, the clause in the Reform Act providing coverage for "assumptions underlying or relating to" forward-looking statements has led several courts to conclude that historical facts that were intertwined with forward-looking statements were themselves entitled to safe-harbor protection. In *Harris v. Ivax Corp.*,¹⁵⁷ for example, the Eleventh Circuit affirmed a lower court dismissal of a securities class action case, holding that a series of forward-looking statements in two press releases were within the safe harbor, and dismissed *without leave to amend*. This important ruling adopts the type of broad interpretation of the safe harbor which industry argued for during the legislative battles preceding the passage of the Reform Act. The court noted that if a statement was forward-looking and was accompanied by meaningful cautionary statements, it was within the safe harbor. Having determined that all of the allegations against Ivax were based on statements that came under the safe harbor, the appellate court affirmed the denial of leave to file an amended complaint.¹⁵⁸

¹⁵⁶ See *In re PLC Sys., Inc. Sec. Litig.*, 1999 WL 191580, at *11 (D. Mass. Mar. 26, 1999); *Cherednichenko v. Quarterdeck Corp.*, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,108, at 90,144 (C.D. Cal. 1997); *In re Stratosphere Sec. Litig.*, 1 F. Supp. 2d 1096, 1117-18 (D. Nev. 1998); *In re Employee Solutions Sec. Lit.*, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,293, at 91,367-68 (D. Ariz. 1998); *In re Boeing Sec. Litig.*, 40 F. Supp. 2d 1160 (W.D. Wash. 1998); *In re Home Health Corp. of Am., Inc. Sec. Litig.*, 1999 WL 79057 (E.D. Pa. 1999).

¹⁵⁷ 182 F.3d 799 (11th Cir. 1999).

¹⁵⁸ *Id.* at 803.

As importantly, the *Ivax* court ruled that cautionary language was "meaningful" even though it did not include an exact enumeration of the fateful potential risk. In *Ivax*, goodwill write-downs were underestimated and the cautionary language did not list such a risk. Addressing this point, the court quoted the legislative history of the Reform Act: "[f]ailure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor."¹⁵⁹ The court went on to say, "[I]n short, when an investor has been warned of risks of a significance similar to that actually realized, she is sufficiently on notice of the danger of the investment to make an intelligent decision about it according to her own preferences for risk and reward."¹⁶⁰ These very points were argued and won in the halls of Congress and the SEC more than five years ago, and the *Ivax* court saw this clearly in the congressional report that accompanied the legislation.¹⁶¹

The *Ivax* court also rejected an argument that a statement need be wholly forward-looking to be covered. The court stated:

[f]orward-looking conclusions often rest both on historical observations and assumptions about future events. Thus, were we to banish from the safe harbor lists that contain both factual and forward-looking factors, we would inhibit corporate officers from fully explaining their outlooks. Indeed, liability-conscious officers would be relegated to citing only the factors that could individually be called forward-looking. That would hamper the communication that Congress sought to foster.¹⁶²

¹⁵⁹ *Id.* at 807.

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *Id.* at 806-07.

This appellate court decision, one of the first to interpret the 1995 Reform Act's safe harbor provisions, is good news for issuers. If other appellate courts hold to this line, public companies should feel safer issuing the kind of good faith projections that investors and analysts continually seek.

2. "Actual Knowledge" Standard

A growing number of courts have held that claims based on forward-looking statements should be dismissed for failure to allege "actual knowledge" on the part of the defendants that the statement at issue was false or misleading when made.¹⁶³ In *Advanta*, the Third Circuit upheld dismissal of claims based on statements made by the company's V.P. of Investor Relations in a Dow Jones article, relating to the company's expected increase in revenues over the next six months. The court found no allegations supporting the conclusion that the person who made the statements did so "with actual knowledge . . . that the statement was false and misleading" — even though plaintiffs alleged the existence of facts that might have undermined the accuracy of the statement at the time it was made.¹⁶⁴

¹⁶³ See, e.g., *Hockey v. Medhekar*, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,465, at 97,083 (N.D. Cal. 1997); *In re Advanta Corp. Sec. Litig.*, [1998 Supp. Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,243, at 91,062-63 (E.D. Pa. 1998), *aff'd*, 180 F.3d 525 (3d. Cir. 1999).

¹⁶⁴ *Id.* at 91,063; see also *In re Home Health Corp. of Am. Inc. Sec. Litig.*, 1999 WL 79057 (E.D. Pa. 1999); *Gross v. Medaphis Corp.*, 977 F. Supp. 1463 (N.D. Ga. 1997).

D. Practical Impact of Safe Harbor

A popular view thus far has been that the statutory safe harbor has not had the desired effect of increasing the quantity or quality of published forward-looking information.¹⁶⁵ We see the litigation landscape changing, however, a fact that should give more companies the courage to start making better forward-looking disclosure.

1. Quantity of Forward-Looking Information

Although issuers appear to be relying on the safe harbor in making oral statements, it seems that companies are continuing to rely on such oral statements in communicating to analysts and institutional investors, thereby taking advantage of the ability to cross-reference published risk disclosures to immunize their oral statements, but *not* making significant additional *written* disclosure. Ironically, the ease of shielding oral statements under the Reform Act's safe harbor minimizes the incentives for companies to make written forward-looking statements, as there is no institutional pressure to do so. A recent study has concluded that there was "no meaningful change in the nature or extent of written forward-looking statements" as a result of the Reform Act.¹⁶⁶

2. Quality of Forward-Looking Information Being Provided

The SEC has criticized the cautionary language used in various disclosure documents as "boilerplate" and overly general, and has indicated a desire to see companies provide more

¹⁶⁵ See Committee on Securities Regulation, "Forward-Looking Statements and Cautionary Language After the 1995 Private Securities Litigation Reform Act," *The Record*, Vol. 53, No. 6, at 726 (Nov./Dec. 1998) (citation omitted).

¹⁶⁶ *Id.* at 736.

forward-looking information *and* improve the quality of the cautionary statements.¹⁶⁷ Several factors may have contributed to the continued reluctance of companies to disclose extensive forward-looking information:

- there is still some confusion in the courts as to what constitutes "meaningful" cautionary statements sufficient to immunize a forward-looking statement. Because the Reform Act codified a version of the "bespeaks caution" doctrine, courts may rely on pre-Reform Act precedent, which, as described above, imposed varying standards of what types of warnings are sufficient to immunize a predictive statement;
- the safe harbor does not apply to actions brought by the SEC, leaving companies open to enforcement actions; and
- because the Reform Act applied only to federal claims, issuers remained subject to liability under the state law.

IV. PROPOSED SEC SELECTIVE DISCLOSURE AND INSIDER TRADING RULES

In response to its growing concerns about selective disclosure, the SEC recently issued proposed new rules that, if adopted, would significantly change the manner in which many corporations interact with the public. Specifically, the proposed new regulations would add:

- a new Regulation FD, which would preclude issuers from intentionally releasing any material nonpublic information to third parties, not subject to confidentiality requirements, unless the issuer also simultaneously released such information broadly to the public. The proposed regulation would also require an issuer who learned it had unintentionally selectively disclosed material nonpublic to make prompt public disclosure of the information.
- a new Rule 10b5-1 under the Exchange Act would clarify the case law split regarding whether "use" of material inside information is required for insider trading liability or, instead, whether mere "possession" of the inside information is sufficient. The new rule imposes liability for trading while "aware" of material nonpublic information unless the trade was made pursuant to a preexisting contract, plan or instruction.

¹⁶⁷ *Id.* at 728.

- a new Rule 10b5-2 would provide that the misappropriation theory of insider trading liability applies when the person who provided the inside information was a spouse, parent, child or sibling unless a showing is made that there was no reasonable expectation of privacy present.

A. Selective Disclosure — Proposed Regulation FD

On December 20, 1999 the Commission took a major step toward ending the practice of selective disclosure by proposing Regulation FD (for "Fair Disclosure") under the Exchange Act.

In the proposing release, the SEC identified three primary issues associated with this practice:

(a) it undermines the fairness of markets by giving an information advantage to analysts to which companies selectively disclose material nonpublic information; (b) it creates an incentive for managers to "hoard" information and parcel it out to curry favor and bolster credibility with particular analysts or institutional investors; and (c) it creates conflicts of interest for analysts, who are likely to feel pressure to report favorably about particular issuers to avoid being cut off from access to the flow of nonpublic information from that issuer.

The newly proposed Regulation FD does not address the issue of selective disclosure through the insider trading laws, but instead focuses on the disclosure process. It would be adopted pursuant to the reporting provisions of the Exchange Act rather than the antifraud provisions (*e.g.*, Section 10(b)), so no private liability would arise. It draws a distinction between intentional and non-intentional disclosures, and would require the following:

- whenever an issuer (or any person acting on its behalf) intentionally discloses material nonpublic information to any other person outside the issuer, it must simultaneously make public disclosure of the same information, and
- whenever an issuer learns that it (or any person acting on its behalf) has made a non-intentional material selective disclosure, it must make prompt public disclosure of that information.

The proposed regulation would apply to all issuers with securities registered pursuant to Section 12 of the Exchange Act and to those issuers required to file reports under Section 15(d)

of the Exchange Act, including closed-end investment companies but not including other investment companies. All disclosures of material nonpublic information made by officers, directors, employees or agents of an issuer to persons outside the issuer (with whom no confidentiality agreement is in place) while acting within the scope of their authority would be covered.

1. Timing and Mechanics

The timing of required disclosures under proposed Regulation FD depends on whether the disclosure of material nonpublic information was intentional or non-intentional. If an issuer makes an intentional disclosure of material non-public information, the proposed regulation would require that it simultaneously publicly disclose the same information. Alternatively, if the disclosure was non-intentional, there must be prompt (but no later than 24 hours) public disclosure "as soon as reasonably practicable" after a senior official knows (or is reckless in not knowing) of the non-intentional disclosure. For purposes of the proposed regulation, a "senior official" is any director, any executive officer, any investor relations or public relations officer or any person with similar functions. The "recklessness" element means that senior officials will need to institute procedures that will make it reasonably likely that they will be notified in the event of a non-intentional disclosure.

There is a certain amount of flexibility in what types of public disclosure will satisfy the requirements of the proposed regulation. In all cases, the filing of a Form 8-K that contains the information will be sufficient. Alternatively, an issuer could satisfy the proposed regulation if it either disseminated a press release containing the information through a widely circulated news or wire service such as Dow Jones, Bloomberg, Business Wire, PR Newswire or Reuters, or if it made public disclosure in another way that was reasonably designed to provide broad public access – such as an announcement at a press conference to which the public is granted access and

for which notice has been provided in a form that is reasonably available to investors. One method that the SEC specifically states will *not* be sufficient, however, is the mere posting the information on the issuer's website (although the proposing release does suggest that such posting is good practice).

2. Materiality

According to the Commission, the new rules do not alter the traditional federal securities law definition of "material." In the proposing release, however, the SEC notes the potential difficulty of determining whether a specific disclosure would rise to the level of "materiality." The release identified four practices already in use that can mitigate the difficulty: (a) issuers can designate a limited number of people who are authorized to make disclosures to or field questions from analysts, investors or the media; (b) issuers can institute a system by which records are kept of the substance of private communications with analysts or investors – such as recording conversations or having more than one person present; (c) issuer personnel can refrain from answering questions until they have a chance to consult with others; and (d) issuer personnel can require analysts to agree not to make use of disclosed information until the personnel have had chance to make a materiality determination. The SEC staff's recent issuance of Staff Accounting Bulletin No. 99, which takes a tough line on materiality and emphasizes that the test is not an objective quantitative one, will have to be considered in the context of making the decisions required by the proposed regulation.

3. Safeguards

At the December 15th meeting in which the SEC announced the proposed rules, outgoing General Counsel Harvey Goldschmid expressed a concern with the potential chilling effect that the selective disclosure rules might have on corporate communications. This concern is also reflected in the proposing release. To address these concerns, he identified four safeguards that

would reduce the risk. First, the proposed regulation is not an anti-fraud rule and is not intended to create duties under Section 10(b) of the Exchange Act. Thus, there will be no private liability from an issuer's failure to comply. Noncompliance could, however, subject the issuer to an SEC enforcement action and could also result in an enforcement action against the personnel at the issuer who are responsible for noncompliance. Second, non-public dissemination of material information is still permitted as long as it is made under a confidentiality agreement. For example, the adopting release specifically contemplates the disclosure of material nonpublic information to other parties to a business combination or with purchasers in a private placement transaction without the necessity of public disclosure if the party receiving the information agrees to hold the information in confidence. Third, the distinction between intentional and non-intentional disclosure should give issuers comfort that an inadvertent disclosure can be remedied. Finally, the wide range of mechanisms for disclosure should give issuers sufficient flexibility to meet the regulation's requirements.

4. Relationship with the Securities Act

The interplay between the requirements of the proposed regulation and the Securities Act is complex. Because Regulation FD would only apply to issuers that have securities registered under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of the Exchange Act, the regulation would not apply during an issuer's initial public offering. A reporting issuer, however, would be subject to the regulation's requirements even during a pending registration. The regulation would thus apply to oral disclosure of material nonpublic information during the "roadshow" for an offering – if such disclosure occurred, the issuer would be required to publicly disclose the same information, a result that differs markedly from current practice which treats oral and written communications around the time of an offering differently.

The SEC also notes that the disclosure required under the proposed regulation could be considered an "offer" of securities for purposes of Section 5 of the Securities Act and a "prospectus" for purposes of Section 2(a)(1) of the Securities Act. Thus, an issuer could violate Sections 5(c) or 5(b)(1) of the Securities Act by making the required disclosures under the proposed regulation – that is, the disclosure could be considered an offer or prospectus that did not comply with the requirements of the Securities Act. To ameliorate such a result, the SEC has proposed new Rule 181 under the Securities Act which would except any public disclosure that is both required by, and compliant with, the proposed regulation from the prospectus requirements of Section 10 of the Securities Act for an issuer that has already filed a registration statement. When a reporting company plans an offering, but has not yet filed a registration statement, however, the Commission views the circumstances as different. Accordingly, it has not extended the exemption in proposed Rule 181 to this situation, but solicits comment on the issue.

B. Clarification of Insider Trading Prohibitions – Proposed Rules 10b5-1 and 10b5-2

In the same proposing release, the Commission also released proposed rules to clarify and enhance existing prohibitions against insider trading. The first is a new Rule 10b5-1, which sets up a framework for clarifying the use/possession distinction in insider trading law, and the second is a new Rule 10b5-2 which clarifies the scope of insider trading liability relating to familial relationships.

1. Use/Possession

Currently, courts are split on whether insider trading liability requires trading merely while in "knowing possession" of material nonpublic information or actual proof that the trader "used" the information while trading (*i.e.*, traded on the basis of). One of the leading cases, *SEC*

v. Adler,¹⁶⁸ required *use* of the inside information, but also invited the SEC to engage in rulemaking on the subject. The Commission has long adhered to the position that liability for insider trading attaches under Section 10(b) and Rule 10b-5 of the Exchange Act whenever a person "possesses" material nonpublic information about an issuer when trading in that issuer's stock. In response to *Adler*, the SEC has proposed Rule 10b5-1 which states the general principle that insider trading liability arises when a person trades while "aware" of material nonpublic information. Tempering this, however, are four carefully enumerated exceptions discussed below.

Proposed Rule 10b5-1 begins with a general prohibition on insider trading that, according to the Commission, codifies existing case law – it is illegal to trade "on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information." The rule then defines trading "on the basis of" material nonpublic information as a trade in which the trader "was aware of" the information when such person made the purchase or sale. Finally, the proposed rule sets forth four affirmative defenses to liability:

- (1) if, before becoming aware of the material nonpublic information, the trader entered into a binding contract to trade in the amount, at the price, and on the date at which the trade was ultimately made;
- (2) if, before becoming aware of the material nonpublic information, the trader had provided instructions to another person to execute the trade in the amount, at the price, and on the date at which the trade was ultimately made;

¹⁶⁸ 137 F.3d 1325 (11th Cir. 1998).

- (3) if, before becoming aware of the material nonpublic information, the trader had adopted and had previously adhered to a written plan specifying purchases or sales of the security in the amounts, and at the prices, and on the dates at which the person purchased or sold the security; or
- (4) from purchases or sales that result from a written plan for trading securities that is designed to track or correspond to a market index, market segment or group of securities.

A trade "in an amount" must specify either the aggregate number of shares or other securities to be purchased or sold, or the aggregate dollar amount of securities to be purchased or sold. A trade "at a price" includes a purchase or sale at the market price for a particular date.

In all cases, the affirmative defenses would only be available if the contract, plan or instruction was entered into in good faith, and not as part of a scheme or plan to evade the prohibitions of the rule. Likewise, any change to the contract, plan or instruction initiated after becoming aware of the material nonpublic information negates the defense. Finally, a person would lose the benefits of the defense if he or she entered into or altered a "corresponding or hedging transaction or position" with respect to the planned trade. This would prevent a person from setting up a hedging transaction and then canceling execution of the unfavorable portion of the hedge. An additional, separate affirmative defense exists for entities that trade. The additional defense requires demonstration that the individuals making the decision on behalf of the entity were not aware of the inside information, and that the entity had implemented reasonable policies and procedures, such as informational barriers and restricted lists, to prevent insider trading.

Interestingly, at the December 15th meeting, General Counsel Goldschmid only referred to one defense. The four defenses in the proposed rule perhaps suggest some last minute maneuvering on the rule prior to its release. In addition, at the meeting Commissioner Unger raised the question as to whether the SEC's new rule, if adopted, would be recognized in a

criminal action after *United States v. Smith*,¹⁶⁹ where the Court indicated, in *dicta*, that a criminal fraud prosecution must meet a higher standard. Mr. Goldschmid indicated that he thought the rule could support such a prosecution.

2. Misappropriation Based on Family or Personal Relationships

The second rule proposal regarding insider trading involves the scope of "misappropriation" liability for insider trading in the context of a family or personal relationship. In essence, it would treat persons with specified familial or personal relationship as constructive insiders. Proposed Rule 10b5-2 provides a nonexclusive definition of the circumstances under which a person has a duty of trust or confidence for purposes of the "misappropriation" theory of insider trading. It is expressly not intended to modify the scope of insider trading law in any other way.

Under the proposed rule, whenever a person agrees to keep information in confidence, a duty of trust or confidence would exist. This principle is designed to pick up the idea that a reasonable expectation of confidentiality can be created by agreement between parties, regardless of whether such agreement is express and written or, instead, an implicit understanding. Second, the proposed rule provides that a "history, pattern or practice of sharing confidences" which gives a person communicating material nonpublic information a reasonable expectation that other person would maintain its confidentiality also creates a duty of trust or confidence in the other person.

The second part of the proposed rule creates a "facts and circumstances" test that is derived from *United States v. Reed*,¹⁷⁰ which recognizes that, in certain situations, a legitimate

¹⁶⁹ 155 F.3d 1051 (9th Cir. 1998).

and reasonable expectation confidentiality on the part of the confiding person may be created by a past pattern of conduct between two parties.

Finally, the third part of the proposed rule creates a bright line liability rule, subject to affirmative defenses, for spousal, parent-child and sibling relationships. Under the proposed rule, even if such a familial relationship does exist, liability would not attach if the person receiving or obtaining the information can demonstrate that no duty of trust or confidence existed under the facts and circumstances of that particular family relationship. The party asserting the defense must show that the disclosing family member did not have a reasonable expectation of privacy by establishing the absence of any a history, pattern or practice of sharing confidences and the absence of any agreement or understanding to maintain the confidentiality of the information.

With the exception of Chairman Levitt, the Commissioners generally seemed skeptical about the wisdom of the Commission involving itself in issues that turn so closely on matters of familial relationship. This reluctance indicates that comments on the proposed rule may be especially influential.

C. What Companies Should Do Now

As an initial matter, the proposed rules may be altered significantly before they are adopted, if adopted at all. Nevertheless, the issue of selective disclosure is of great concern to the SEC, and it is looking to bring an enforcement action as a test case. Accordingly, this is a good opportunity for companies to review their current disclosure practices. Likewise, the

[Footnote continued from previous page]

¹⁷⁰ 601 F. Supp. 685 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 447 (2d Cir. 1985).

proposing release outlines the Commission's current thinking on insider trading, and thus is useful guidance on the types of insider trading enforcement actions that the SEC may bring.

- ***Comment on the Proposals.*** In light of the relatively lengthy comment period and the apparent level of skepticism with which the proposed rules were greeted by the Commissioners other than Chairman Levitt at the December 15th open meeting, interested parties should strongly consider formally commenting on the proposed rules.
- ***Contacts with Analysts and Investors.*** Now is also a good time for a review of corporate practices and policies regarding interaction with analysts and investors. Issues to focus on in such a review include access to and the content of conference calls, who is authorized to speak on behalf of the company, and the advisability of engaging in practices such as informal comments on analysts earnings projections.
- ***Materiality and SAB 99.*** Companies should also consider the processes they follow in making materiality determinations. The proposing release identified four practices already in use that can mitigate the difficulty, which are discussed above. In addition, the SEC staff's recent release, SAB 99, giving guidance on the nature of information deemed to be material in financial statements that should be reviewed in the context of proposed Regulation FD.
- ***Review of Corporate Insider Trading Policies.*** Companies should review their corporate insider trading policies to be sure that they are consistent with the SEC's view of "awareness" as the appropriate test. Irrespective of whether the proposed rules are adopted, the SEC has made it clear that it views awareness of material inside information while trading as impermissible, except in extremely limited circumstances. Furthermore, companies should review their corporate insider trading policies to be certain that they caution employees that they need to be concerned about trades by family members, particularly those who will fall within the new presumptive definitions of proposed Rule 10b5-2. Finally, companies should consider extending prior approval requirements for transactions in company securities to members of families of key insiders who would fall within the proposed rule.
- ***Advice Regarding Disposition Programs.*** Companies should also give those officers, directors and substantial shareholders who have disposition programs for company shares additional guidance on the mechanics of such programs based on the proposed rules. This could include, for example, recommendations that they document their decisions to divest in writing, have the decision approved by counsel when made, and perhaps even recommend that such persons implement the divestitures through an independent bank trustee or brokerage firm operating under irrevocable instructions to implement the divestiture program.