

June 13, 2000

The Honorable Arthur Levitt
Chairman, United States Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt:

Thank you for meeting with Marc Lackritz and us on May 30 to discuss the Commission's proposed Regulation FD. We thought that it was a helpful exchange of views. We would like to elaborate on a few of the points that we discussed at that meeting. We also are enclosing a separate letter to Commissioner Hunt, responding to a speech that he made on this topic, which amplifies on our concerns.

We agree with you that corporate officials should not selectively disclose material information to selected analysts or investors for nefarious motives. Unfortunately, Regulation FD misses this goal, and instead creates a serious, albeit unintended, threat of discouraging the flow of corporate information into the market. We hope that you will give this concern serious consideration in deciding how to proceed.

In light of the Supreme Court's decision in Dirks v. SEC, it puzzles us why the Commission Staff, if it felt that a new rule was necessary in this area, did not focus on a fraud-based regulation clarifying the "personal benefit" test of Dirks. Alternatively, the Staff could have proposed a rule somewhat akin to Regulation FD, but which covers only communications initiated by the issuer. This would focus the regulation on unsolicited communications by issuers seeking to curry favor with an outside party, which we understand to be the essence of the Commission's concerns. At the same time, risk of inhibiting useful communications might be reduced.¹ Approaches such as these might balance our concern about chilling communications that are good for the market with the Commission's desire to address issuers who "treat material information as a commodity

¹ Of course, an approach that carved out communications initiated by outsiders would still sweep up, and discourage, communications with outsiders that would improve market knowledge. While we would therefore still question the need for such a regulation, this approach would be preferable to proposed Regulation FD insofar as it would (i) enable analysts to approach issuers in ways that would be clearly permissible, (ii) to some degree preserve analysts' ability, as emphasized in Dirks, to "ferret out and analyze information . . . by meeting with and questioning corporate officers and others who are insiders," and (iii) offer a deterrent beyond existing law against an issuer tempted to solicit outsiders with inside information in return for an improper *quid pro quo*.



that can be parceled out selectively... to curry favor or bolster credibility with particular analysts or institutional investors.”²

Both the Commission and we start from the premise that the health of the markets depends on the maximum flow of information to issuers through all available channels. Recent years have seen a significant increase in the flow of this information. The Internet in particular has given rise to both a widespread demand for more information and an ability on the part of issuers to respond to that demand. You and your staff also deserve credit for this increase. By criticizing inappropriate disclosure practices and encouraging greater openness, the Commission has caused issuers to improve their disclosure practices. This is demonstrated by the results of the recent survey of the National Investor Relations Institute (“NIRI”), showing that 83 per cent of the responding companies conduct conference calls, and 82 per cent of those allow individual investors real-time access (up from 29 per cent two years ago). These numbers can be expected to continue climbing in the absence of any regulatory initiative.

Regulation FD represents a significant effort to move toward an ideal that all market participants should possess equal information. This conflicts with the reality that economic incentives to motivate individuals to aggressively pursue and piece together information are at the heart of an efficient marketplace. The law of insider trading, stated in a nutshell, is that betting on a known outcome is unfair. Profiting in the market by one’s hard work, intelligence and ingenuity is fair.

There is ample evidence in the comment letter file on Regulation FD showing that it goes far beyond its stated goal of deterring issuers from using inside information as a commodity that can be improperly traded for a benefit. Instead, it will discourage communications between issuers and analysts *on both sides* of the dialogue, in situations where those communications are desirable for the markets. On the issuer side, the comment letter from NIRI, among others, explains how the rule is likely to dampen voluntary issuer disclosures. NIRI’s concerns are especially germane since the Staff has indicated that the rule was largely modeled on NIRI’s guidelines for issuer disclosure.

“[o]ne consequence of adopting the proposed rule would be to change the way many companies provide earnings guidance to the financial community[O]ne major law firm in Silicon Valley is now recommending that clients issue their earnings guidance in the quarterly earnings release, invoking the safe harbor for forward-looking information, and stay ‘quiet’ for the remainder of the quarter, with no updating should the initial projections change. . . .NIRI’s concern, expressed by two board members from Silicon Valley, is that a number of companies might adopt this model, should this proposed rule be passed, thereby significantly impacting the intra-quarter flow

² Regulation FD Proposing Release, 64 F.Reg. 72590, 72592 (Dec. 28, 1999).



of information between companies and the financial markets that helps reduce stock price volatility.”³

Disincentives to seeking out this information will also be created on the side of analysts and mutual funds, pension funds and other institutional investors. The rule will weaken the economic incentive to invest time and energy in ferreting out information. By effectively forcing all substantive communications between issuers and analysts and investors into a public forum, these individuals will find it difficult or impossible to ask probing questions, both because they will be reluctant to reveal their own thinking or internal research to competitors, and because the nature of the forum will make it difficult to doggedly pursue a line of inquiry, or to have a dialogue about highly technical scientific or financial matters. In turn, this will reduce the value of the analyst’s own product, and thereby weaken the incentive for institutions to employ teams of analysts with highly specialized training in fields such as physics, computer science, genetics, microbiology, pharmacology, etc. While this erosion will not happen overnight, we believe that the inevitable result will be the devaluation of market analysis.

In the Dirks case the Supreme Court anticipated the problem that underlies the Regulation FD proposal. The Court observed that the ideal of perfect parity of information unavoidably conflicts with the role of analysts (and of other information agents such as the press and rating agencies), because it threatens

an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts [as well as financial reporters and rating agencies, SIA might add] to ‘ferret out and analyze information’ [citing to SEC source] and this often is done by meeting with and questioning corporate officers and others who are insiders. . . . *It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation’s stockholders or the public generally.*⁴

In the years since Dirks nothing has changed to alter the fundamental role of analysts as described by the Supreme Court. The Commission’s release points to the revolution in communications and information technology as obviating the need for analysts to serve as information intermediaries. This misconceives both the nature of the changes that technology has brought about and the role of analysts. While it is feasible today to place almost infinite bits of information in the hands of investors, this in no way

³ Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Bonnie Burdett Dennis and Louis M. Thompson, Jr., National Investor Relations Institute, April 11, 2000, at 11.

⁴ Dirks v. SEC, 463 U.S. 646, 658-59 (1983).



supplants the need for someone with the skills to closely question corporate officials about their business. For example, it is dubious that the Internet has empowered most investors to make informed judgments about the physics underlying a new silicon chip on which a manufacturer's business prospects turn.

The Court in Dirks also recognized that the parameters of Rule 10b-5 could not reach a gray area of conduct that may be troubling, but is not unlawful. The Court hinted that this is a problem that cannot be solved by any exercise of rule-writing. The Justices pointed out, as the Commission itself has conceded in other contexts, that "in a statutory area of law such as securities regulation, where legal principles of general application must be applied, there may be 'significant distinctions between actual legal obligations

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We submit that attempts to bridge this gap between legal obligations and ethical precepts with the blunt instrument of new regulations are bound to do more harm than good. Instead, we think the wisest course is for the Commission to place more faith in the power of investor demand and technology, as well as its own moral suasion and evolving private standards of practice.

Again, thank you for meeting with us. If you have any questions, please contact us or George Kramer of the SIA staff at 202-296-9410.

Sincerely,

Lee B. Spencer, Jr.
Chairman
Ad Hoc Working Group on
Regulation FD

Stuart J. Kaswell
Senior Vice President and
General Counsel

Cc: The Honorable Isaac C. Hunt, Jr.
The Honorable Paul R. Carey, Commissioner
The Honorable Laura S. Unger, Commissioner
David Becker, General Counsel, Office of General Counsel
Harvey Goldschmid, Adviser to the Chairman
Meyer Eisenberg, Deputy General Counsel
Steven Cutler, Deputy Director, Division of Enforcement

⁵ Dirks at 463 U.S. at 661, fn 21.