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FERRETING IN THE INTERSTICES OF S.E.C. ATTITUDES TO SECURITIES ANALYSTS

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The point and place of beginning for lawyers giving advice on company-analyst contacts must of course be the Supreme Court's opinion in the Dirks case. Justice Powell wrote, deliberately:

> Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information," [citing to the SEC's opinion below] and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally. (footnotes omitted)[1]

The core of Justice Powell's conclusion (what Professor Loss calls his "paean to the analyst"[2]) was taken from the S.E.C.'s own Dirks opinion.

> [Analysts] are in the business of formulating opinions and insights -- not obvious to the general investing public -- concerning the attractiveness of particular securities. In the course of their work, analysts actively seek out bits and pieces of corporate information not generally known to the market for the express purpose of analyzing that information and informing their clients who, in turn, can be expected to trade on the basis of the information conveyed. The value to the entire market of these efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by such initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors. (footnote omitted)[3]

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1 Dirks v. S.E.C., 463 U.S. 646, 658-9 (1983).

2 Loss, Fundamentals of Securities Regulation (2d Ed.) 769.

3 In the Matter of Raymond L. Dirks, 47 S.E.C. 434, 441 (1981).

Now, if the SEC believes that -- if the SEC accepts what Justice Powell wrote for the Supreme Court -- one wonders what we have to discuss this afternoon. The fact is that the SEC does not accept Dirks, nor does the SEC believe its own "paean" to the analysts appearing in its own Dirks opinion -- and that's why the subject gets onto the curriculum of this and other Securities Institutes.

I've overstated, but not by much. The SEC does accept and does believe, but only in the generality. My understanding can be summed up in what almost sounds like a syllogism:

1. In the generality, the SEC believes firmly in the legitimate exercise of the analytical function, including the analysts' pursuit of additional information from issuer personnel;

2. When it comes to the particular, the SEC has never seen an exercise of the analytical function that it believes to be legitimate; and

3. Therefore, the SEC not only wants to keep company-to-analyst contacts in the status of "a fencing match on a tightrope" (to use the Bausch & Lomb language)[4] -- it's trying hard to electrify the tightrope.

Now, let's back up to the pre-Dirks era. In another incarnation I used to tell corporate clients: if you're really angry at an analyst (because there's always an analyst who's taking potshots at any company), tell the analyst something material, tell her that you've told her something material, and tell her that your next call will be to her chief so that her chief can know you've told her something material. The result, in those days, was clear: the whole firm (or institution) would be barred from trading or recommending the company's securities until the company (or the firm) made the information public.

After Dirks I had to go to all those clients and say, "That advice no longer holds; the analyst can now thumb her nose at us and pass the information on to clients." And I wasn't alone. I've found CLE program outlines by Dick Phillips and by Mike Eisenberg that said much the same thing:

> [U]nless the analyst is knowingly aiding an insider to benefit from the use of information about his company, the analyst may generally advise clients to trade based on information that comes into his possession, even if the information is clearly material and nonpublic,

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[4] S.E.C. v. Bausch & Lomb, Inc., 565 F.2d 8, 8-9 (2d Cir. 1977).

without fear of liability for insider trading.[5]

And I heard Professor Loss call Dirks a "magna charta" for the analysts, in an ALI-ABA presentation shortly after Dirks. But it didn't take very long for me (and the others) to realize that the Enforcement Division and the Commission hadn't changed, that the word had gone out from 450 5th Street that the tightrope had not been taken down, hadn't even been fitted with a safety net, and that the swordsmanship would have to be kept just as sharp.

Why? Because the SEC believes now, as it believed before Dirks, that prohibiting the transmittal to analysts of material nonpublic information

- will "not preclude 'the exercise of customary institutional information gathering functions -- the process by which bits and pieces of corporate information are integrated and analyzed for investment decisionmaking purposes ...'";

- will "not inhibit analysts' customary research or impair market efficiency. Analysts remain free to obtain from corporate management corporate information that is not itself material for purposes of filling in the 'interstices in analysis' and 'testing the meaning of public information ...' about corporate activities.";

- accords fully and appropriately with "Congress' decision to leave 'intact' the traditional insider trading doctrine ..."; and

- is well within the Commission's responsibility for ensuring that our securities markets are fair and efficient, and "courts are not free to 'disregard [an] agency's view' of one of its own statutes and to construe the statute based on [the courts'] 'own view of what would best serve the purposes and policy' of the statute".

Each quote is from the Commission's brief in Dirks[6] -- and I'm

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[5] Eisenberg, Dirks v. S.E.C.: Implications for Financial Analysts, prepared for ALI-ABA Program "The New Face of Insider Trading: Chiarella, Dirks, and Beyond" (1983). See, also, Phillips, Insider Trading After Dirks, 16 Rev. of Secs. Reg. 841, 844 (1983).

[6] Dirks v. S.E.C., Brief for the Securities and Exchange Commission In the Supreme Court of the United States, at 43, 42, 38 and 42 n. 53, respectively.

convinced that the Commission would write the very same brief today.

All that being so, what's there to talk about? Well, on a practical level, on a lawyering level, when you are called in to deal with a disclosure to analysts (prospectively, before the contact takes place, or, more usually, retrospectively, when the company official or the analyst recognizes that she's got a problem), be sure that you take a good hard look, first, at whether your problem stems from an interview with the media or perhaps a meeting with securities analysts in a sizeable and disparate group -- take a hard look, in other words, at whether you can get away from what was and still is called, pejoratively, "selective disclosure". "Selective disclosure" is trouble -- it's a red flag in front of a bull, both in the Enforcement Division and at the Commission table. For my part, I have thought, since 1971, that then-Commissioner Smith's Investors Management insight:

> It is important ... to focus on policing insiders and what they do ... rather than on policing information per se and its possession.[7]

should be taken as the fundamental principle on which the law governing insider trading and tipping should be built (and I therefore took great heart from Justice Powell's quotation of that very insight[8]). In the "policing [of] information" conveyed to and through analysts, Commissioner Smith went on to write not only that the "quantum informational advantage [resulting from "the quest for new knowledge by analysts"] ... is not violative of the securities laws"[9] in the absence of what we now refer to as an insider's "breach of duty", but also, similarly, that "selective revealment ... is improper only if done in breach of a duty owed to the corporation."[10] However persuasive I may find that argument, I must repeat that, to both the Division and the Commission, any selective disclosure carries a near-irrebuttable presumption of breach.

If the problem does involve selective disclosure and you're concerned from the analyst's side, be sure that you also look hard at how broadly and how close-to-simultaneously the analyst conveyed the information to clients, and at whether the

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7 In the Matter of Investors Management Co., Inc., 44 S.E.C. 633, 648 (concurring opinion of Comm'r. Smith) (1971).

8 Dirks, supra n. 1, at 660-1.

9 Investors Management, supra n. 7, at 649.

10 Id., at 650.

information went first to clients or first to the firm's trading desk. The Enforcement Division, if not the Commission, is aware that Justice Powell sought to protect a sphere of analysts' activity beyond that described as merely "filling the interstices in analysis", and will respect the analyst's Dirks protection at least if materiality is arguable. If materiality is clear, I would hazard a guess that the Division would treat the analyst as a knowing participant in the insider's breach -- because, as I've already suggested, that the insider has breached is virtually an article of faith; the only open question is how the Commission articulates his or her personal benefit.

So, if your problem involves selective disclosure and your concern is from the company officer's point of view, be aware that the fundamentals of the law haven't been changed by Dirks in the eyes of the SEC[11] -- only the way to plead the case has changed. With that in mind, let's review each of the necessary elements in turn.

As to materiality, the Commissioners are of course presented with Basic[12] and Northway[13], but the shape of the figure on the skeletal Basic/Northway structure is still sketched out with the Geon crayon: any information that "'in reasonable and objective contemplation might affect the value'"[14] of the securities should be deemed material. And the Commissioners are presented with the Bausch & Lomb "index of materiality" that people-who-received-and-understood-the-information-did-trade,[15] and with the Texas-Gulf-type proof of materiality that the-company-subsequently-thought-the-information-sufficiently-important-to warrant-public-disclosure.[16]

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11 See S.E.C. brief, supra n. 6, at 31.

12 Basic, Inc. v. Levinson, 485 U.S. 224, 108 S. Ct. Rep. 978, 987 (1988).

13 TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

14 S.E.C. v. Geon Industries, Inc., 531 F.2d 39, 47 (2d Cir. 1976), quoting from Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963) via List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965) and S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (emphasis added in Texas Gulf Sulphur opinion).

15 Bausch & Lomb, supra n. 4, at 18.

16 S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 847 (2d Cir. 1968) (the Court's opinion doesn't articulate this "proof", but perhaps it is implicit in the facts of the case).

As to dissemination, the fact that some analysts have interpreted other company information to reach the conclusion that is implicit or explicit in the selectively-disclosed information, and have so advised the marketplace, can't be considered to have made the information "public" without confirmation by a company source. (And don't forget that company-sourced information may itself require verification,[17] and of course is the very type of information that gives rise to the likelihood of an "inside information" prosecution.[18])

As to scienter, forget the portion of Dirks that says:

> For example, it may not be clear -- either to the corporate insider or to the recipient analyst -- whether the information will be viewed as material nonpublic information. Corporate officials may mistakenly think the information already has been disclosed or that it is not material enough to affect the market.[19]

The true faith holds that a finding that the corporate official had reasonable grounds to believe that the particular information was both material and different (as material information must be) from information publicly available, and that the corporate official nonetheless failed to abstain from disclosure to the analysts and failed to disclose such facts to the public -- the true faith holds that that finding is itself proof of recklessness. (I needn't point out that there are always reasonable grounds to worry about materiality.)

As to personal benefit, look to reputation:[20]

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17 In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc., Sec. Exch. Act Rel. No. 14149, 13 S.E.C. Docket 646, 648-651 (1977).

18 Id., at 651.

19 Dirks, supra n. 1, at 662.

20 See SEC v. Stevens, No. 91 Civ. 1869 (S.D.N.Y. March 19, 1991). "The Commission's Complaint alleges that ... Stevens placed a series of unsolicited telephone calls to several securities analysts that provided research coverage for Ultrasystems to give the principal analysts information concerning Ultrasystems' quarterly results, in order to protect and enhance his reputation. The Complaint alleges that that action was seen by Stevens as having direct, tangible benefit to his status as a corporate manager." SEC Litigation Rel. No. 12813 (March 19, 1991).

- Is the disclosing officer reasonably new to his job? He wants to build a reputation for himself.
- Is the disclosing officer long in her job? She wants to reaffirm that she's not riding on her laurels and she wants to create the same reputation among newer analysts.
- Has the disclosing officer previously had problems with credibility, by exaggerating in the company's behalf or by being caught by subsequent unexpected events? He's trying to redeem his reputation.
- Has the disclosing officer a good record and an established credibility with the analysts? She's struggling to maintain that reputation.

Remember: the disclosing officer's job is to be credible; reputation is her only proof of credibility; so in that job reputation translates directly into salary/bonus/options. And remember, too: if the disclosing officer hadn't been concerned with her reputation for personal purposes, as a matter of professional judgment she would have avoided selective disclosure -- you know that (or, if you don't, you too are presumably reckless).

So: materiality, non-dissemination, scienter, and personal benefit creating a breach -- all the elements are in place. And, with the elements in place, the Enforcement Division and the Commission both know that the process of company-to-analyst contact can be chilled as well from the company's as from the analyst's window -- that the tightrope can be stretched as taut from the company's as from the analyst's highwire platform.

The ultimate question is why? What are the benefits and detriments of a policy determination to chill or not to chill, to encourage or not to encourage? As you search for the answer in order to know how to counsel your clients, I commend to you both Professor Langevoort's recent essay[21] and Professor Fischel's older analysis.[22]

Professor Fischel stresses the benefits created by the analysts' information-gathering activity, particularly in reducing problems of asymmetric information -- that is, in assisting investors to distinguish among and select from the universe of securities. The analyst's "comparative advantage in

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21 Langevoort, Essay -- Investment Analysts and the Law of Insider Trading, 76 Va. L. Rev. 1023 (1990).

22 Fischel, Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission, 13 Hofstra 127 (1984).

interpreting, verifying and seeking out information"[23], Professor Fischel asserts, is useful to and used by companies and public investors alike, and the analyst's monitoring function, to maintain his or her own reputation for credibility, complements the communicative and interpretative role. The aggregate information benefits convince Professor Fischel that insider trading rules should be so applied as to give free rein to the company-analyst contact.[24]

Professor Langevoort (like former Chairman Ruder), by contrast, stresses the inapplicability, in a wide range of analyst contexts, of Justice Powell's underlying premise -- namely, that the analyst is gathering information for the benefit of a wide spectrum of clients, including retail investors. "Intuition suggests",[25] Professor Langevoort says, that the retail clients as a group will not get the information as quickly as (not to say ahead of) large institutional clients. And what of the analyst who works only for one institutional client? Justice Powell might well not have written the same opinion if Ray Dirks had worked for a large multi-departmental firm and had taken the information <u>only</u> to that firm's trading desk, setting aside <u>all</u> the firm's clients regardless of category. The use -- or, if you'd like, the potential <u>ab</u>use -- of information by analysts tilts what Professor Langevoort properly sees as an ambiguous balance, in the applicability of insider trading rules, to chill if not to freeze the company-analyst contact.

To me, as to Professor Fischel, that conclusion is the wrong one. I see the company-to-analyst contact -- the process of contacts -- as inherently desirable. I remember too many instances when a corporate CFO sought, as best he could, to perform the communications side of his job credibly, reviewing current cost of sales or book-to-bill ratios on a weekly if not daily basis -- always at risk that some <u>single</u> figure, out of the entire amalgam, would subject him and his company to prosecution for selective disclosure of material information. I believe strongly that that should not be so. I know that the process <u>may</u> be abused, but I see the general inhibition on disclosure resulting from fear of the unrecognized material item as more costly and more harmful to the aim of disclosure promotion than is the isolated instance of abuse for the disguised personal benefit of either the company official or the analyst. And I see no help in protecting the analyst if the company official can and

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23 <u>Id.</u>, at 142.

24 <u>See</u>, <u>also</u>, Easterbrook, <u>Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information</u>, 1981 Sup. Ct. Rev. 309, 337.

25 Langevoort, <u>supra</u> n. 18, at 1026.

will be sandbagged. But the fact remains that my views, in 1991, are decidedly _not_ the Commission's views.

The Commission remains dedicated to the beneficence of the legitimate performance of the analysts' function. When, however, it is presented with a specific case, the Commission, applying a process that Professor Fischel described as "legal analysis ... reduced to a vacuous recitation of clichés and talismanic phrases devoid of analytical content",[26] has yet to find an exercise of the analyst's function that it finds to be legitimate. The change, due to _Dirks_, is that in 1991 the Commission is _un_likely to prosecute today's equivalent of Ray Dirks; our likely target is today's equivalent of Ronald Secrist -- the company official.[27] And, under the new Enforcement Remedies Act,[28] we can charge, try, and hear the appeal of, that company official in in-house administrative proceedings (which were applicable only to Ray Dirks 10 years ago).

Using a phrase that I saw today for the first time (though in a different context), the Commission in 1991 believes that no result other than authorization of prosecution of at least the company official can be reached, in the balancing of interests in this area, "without seriously undermining the Government's [_i.e._, the Commission's] ability to fairly and effectively fulfill its mandate to enforce the law."[29] Now _there_'s a carefully-articulated, sensitively-balanced standard, by which you, your clients, the Commission and the Commission's staff can, with measured study, predetermine or post-assess the propriety of

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26 Fischel, _supra_ n. 19, at 129.

27 _See_ SEC Litigation Release No. 12813 (March 19, 1991), _supra_ n.20.

28 Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990).

29 _In the Matter of The Stuart-James Co., Inc._, Sec. Exch. Act Rel. No. 28810, 48 S.E.C. Docket (CCH) 22, 27 (1991). _Compare_: "While, of course, the Commission has not prohibited analysts from exploring public records to substantiate rumors of criminal conduct, few corporate conspiracies can be uncovered without obtaining information from an inside source. The Commission's approach, therefore, is certain to reduce, and may well eliminate, the role of securities professionals in detecting and analyzing major corporate crimes....In our view, such a result would have a significant adverse effect on federal law enforcement." _Dirks v. S.E.C._, Brief for the United States as _Amicus_ _Curiae_ in Support of Reversal In the Supreme Court of the United States, at 27-8.

conduct not only in this but in almost every other area of concern under the federal securities laws!