The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

**MEMO# 11500**

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# SEC PROPOSES SELECTIVE DISCLOSURE AND INSIDER TRADING RULES

1 Securities Act Release No. 7787 (December 20, 1999), 64 FR 72590 (December 28, 1999) ("Release"). A copy of the Release is attached. [11500] December 29, 1999 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 52-99 EQUITY MARKETS ADVISORY COMMITTEE No. 41-99 SEC RULES COMMITTEE No. 113-99 RE: SEC PROPOSES SELECTIVE DISCLOSURE AND INSIDER TRADING RULES

_____ The Securities and Exchange Commission ("SEC") has proposed new rules to address three issues: the selective disclosure by issuers of material nonpublic information; whether insider trading liability depends on a trader's "use" or "knowing possession" of material nonpublic information; and when the breach of a family or other non-business relationship may give rise to liability under the misappropriation theory of insider trading.1 The SEC's proposal is summarized below. Comments on the proposal are due to the SEC no later than March 29, 2000. Please provide any comments you have on the proposals for possible inclusion in the Institute's comment letter to Amy Lancellotta by phone at 202/326-5824 or by email at amy@ici.org. by February 4, 2000. Selective Disclosure Rule; Regulation FD (Fair Disclosure) To address concerns about selective disclosure, the SEC has proposed new Regulation FD under the Securities Act of 1933, which, rather than treating selective disclosure as a type of fraudulent conduct, creates new issuer disclosure requirements. Regulation FD would require that whenever an issuer, or any person acting on its behalf, discloses material nonpublic information to any other person outside the issuer, that issuer must simultaneously (for intentional disclosures) or promptly (for non- intentional disclosures) make public disclosure of that same information. Therefore, under the proposed rule, whenever an issuer makes an intentional disclosure of material nonpublic information, it must do so in a manner that provides general public disclosure. In the case of an unintentional selective disclosure, the issuer must make full public disclosure promptly after it learns of the selective disclosure. Under the proposal, issuers could comply with the "public disclosure" requirement by filing a Form 8-K with the SEC containing the information. Alternatively, an issuer could disseminate a press release containing the information through a widely circulated news or wire service or disseminate information through any other method of disclosure that is reasonably designed to provide broad public access and does not exclude access to any members of the public. The proposal does not define the 2 The Release states that under the federal securities laws, information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision, or if it would have significantly altered the "total mix" of information made available. With respect to the term nonpublic, the Release states that it is well established that information is nonpublic if it has not been disseminated in a manner making it available to investors generally. 2 terms "material" or

“nonpublic,” but instead relies on the same definitions as are generally applicable under the federal securities laws.2 Proposed Regulation FD would apply to all issuers with securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 (“Exchange Act”) and those issuers required to file reports under Section 15(d) of that Act, including closed-end investment companies but not including other investment companies. The SEC concluded that Regulation FD would offer little additional protection to investors in such other investment companies inasmuch as those funds are continually offering their securities to the public and therefore are required to update their prospectuses to disclose material information subsequent to the effective date of the registration statement or any post-effective amendment, and they are not permitted to sell, redeem, or repurchase their securities except at a price based on their securities’ net asset value. The SEC solicits comment, however, on whether any investment companies should be covered by Regulation FD, and if so, which types should be covered. Insider Trading Issues The Release notes that since neither Congress nor the SEC has expressly defined the term “insider trading” in a statute or rule, insider trading law has developed on a case-by-case basis under the antifraud provisions of the federal securities laws. Consequently, there have been issues on which various courts have disagreed. The SEC has proposed new rules under the Exchange Act to address two issues on which disagreement remains. 1. Proposed Rule 10b5-1: “Use/Possession” Issue It is unsettled whether the SEC must show in its insider trading cases that the defendant “used” the inside information in trading, or merely that the defendant traded while in “knowing possession” of the information. Proposed Rule 10b5-1 would state the general principle that insider trading liability arises when a person trades while “aware” of material nonpublic information, with certain exceptions. The proposed rule would provide exceptions to liability where, before becoming aware of material nonpublic information, a person had (1) entered into a binding contract to trade in the amount, at the price and on the date at which he ultimately traded, (2) provided instructions to another person to execute a trade for the instructing person’s account, in the amount, at the price and on the date at which the trade was ultimately executed, or (3) 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. The rule also provides an affirmative defense for 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. 2. Proposed Rule 10b5-2: Misappropriation Cases Based on Family or Personal Relationships Under the “misappropriation” theory, a person commits fraud in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by misappropriating material nonpublic information for securities trading purposes, in breach of a duty of loyalty and confidence. The theory’s application is 3clear in cases involving misappropriation of confidential information in breach of an established business relationship, such as an attorney-client relationship. It is not as settled, however, under what circumstances certain non-business relationships, such as family and personal relationships, may provide the duty of trust or confidence required under the misappropriation theory. The SEC has proposed a new rule under the Exchange Act, Rule 10b5-2, to clarify the law in this area. Proposed Rule 10b5-2 would set forth three non-exclusive bases for determining that a duty of trust or confidence was owed by a person receiving information: (1) when the person agreed to keep information confidential; (2) when the persons involved in the communication had a history, pattern or practice of sharing confidences that resulted in a reasonable expectation of confidentiality; and (3) when the person who provided the information was a spouse, parent, child, or sibling of the person who received the information, unless it were shown affirmatively, based on the facts and circumstances of that family relationship, that there was no reasonable expectation of confidentiality. Amy B.R. Lancellotta Senior Counsel

Attachment

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