FIRESIDE CHAT – REGULATION FD AND REAL-TIME DISCLOSURE
TUESDAY JUNE 14, 2005

THERESA GABALDON: Good afternoon. I'm Theresa Gabaldon, Professor of Law and Carville Dickinson Benson Research Professor of Law, at The George Washington University Law School, and this year's host of the Fireside Chats of the Securities and Exchange Commission's Historical Society. The Securities and Exchange Commission Historical Society is a non-profit organization, separate from and independent of the SEC. The Society preserves and shares the history of the SEC and of the securities industry through its virtual museum and archive at www.sechistorical.org. Today's chat will be preserved in the museum so you can listen to the discussion or read the transcript later.

Today's Fireside Chat looks at Regulation FD, or Regulation Fair Disclosure, and Real-Time Disclosure. Our panelists today are Dixie L. Johnson, a partner with Fried Frank Harris Shriver & Jacobson LLP, and Laura S. Unger, a Commissioner with the U.S. Securities and Exchange Commission from 1997 to 2002. The 2005 Fireside Chat Series is made possible in part due to support of Pfizer, Inc. The remarks made today are solely those of the speakers and are not representative of the Society. Our speakers cannot give investment or legal advice.

Dixie, Laura, I'd like to start with just a bit of background describing the regulatory scene shortly before the debut of Regulation FD. First, we had substantial disclosure requirements at the time of a public offering of securities. Second, we had periodic reporting pursuant to which publicly-held companies filed annual and quarterly reports with interim updates for exceptional events. Third, we had broad anti-fraud rules with several common, though confusing, applications that prohibited, of course, outright lying in connection with the purchase or sale of a security. They imposed a duty of disclosure if you had something akin to a fiduciary relationship with your trading partner. They arguably imposed a duty to correct and/or update past statements still lingering in the marketplace, and, oh yes, they precluded insiders from benefiting by passing on information to tipees, but permitted the leaking of information for the issuers benefit. And then there came Regulation FD. Laura, could you tell us what that is?

LAURA UNGER: Well, I think before we start, Theresa, in the spirit of fair disclosure, I should say, and lest people question the wisdom of today's participants, it's not really a Fireside Chat in 95 degree weather in Washington, D.C. We should be roasting s'mores or something.

Yes, of course, I remember very well the whole foundation and sort of environment leading up to the proposal of regulation FD and the discussions about the rule itself, and that was the frustration by many investors and the then-Chairman of the SEC, Arthur Levitt, about the fact that investment professionals were in effect getting an upper hand in terms of information in the marketplace, and that in conversations with public company issuers, they were learning about events before the rest of the marketplace, and passing them on. Analysts were passing them on to the trading side of the Wall Street investment firms and then their favorite customers were able to trade on that information. So the notion underlying or underpinning the rule was to create more fairness, ergo fair disclosure in that information flow.

THERESA GABALDON: And what does that regulation provide?

LAURA UNGER: The regulation provides that any issuers who are conveying information to investment professionals, not convey material, non-public information unless they simultaneously or soon thereafter if they mistakenly convey it, convey it to the rest of the marketplace. So it basically prohibits any material, non-public information escaping an issuer's lips to an investment professional.

THERESA GABALDON: Dixie, how do you see that fitting into the overall structure of the securities' laws? Would you say that that's an anti-fraud measure? Is it part of on-going disclosure or is it all about fairness?

DIXIE JOHNSON: It is designed to prevent selective disclosure, as Laura said. It's not a fraud rule. It's not an anti-fraud rule. If you violate it, you haven't committed fraud, but it is an insurance that issuers will need to provide information fairly across the marketplace.

THERESA GABALDON: Do you think that it could be described as the best possible model for achieving its purpose?

DIXIE JOHNSON: Well, it was very controversial at the time. In fact, then-Commissioner Unger dissented from adoption of the rule at the time it was passed. It was controversial for several reasons. One was there was a concern over how much proof there was of a need for that disclosure rule. Two, there had grown up a practice of sharing information with analysts that many people felt got more information into the hands of investors because it was a more informal disclosure process, what most people felt was largely immaterial information. The argument, though, is that if it's really immaterial, it's not prohibited by Regulation FD, you can continue doing it. If it is material, then it shouldn't have been happening selectively at that time.

LAURA UNGER: Which actually, and we can go back and touch on any one of the topics, but interestingly enough, even with Regulation Fair Disclosure, you can have a number of pieces of immaterial information that then lead to a material piece of information and that these immaterial pieces would not be a violation of fair disclosure. The problem is in practice, nobody really knows when you cross the line from immaterial to material, and so one of the main concerns, and one of my main concerns was the flow of information. The Supreme Court had clearly said in the case law that there is no expectation and no requirement that there be parity of information in the marketplace, and in my mind, you asked a very good question, which was how does this fit into the regulatory regime? It should be something that focuses on fraud and it doesn't. It focuses on communication. It doesn't focus on the trading, which is the actual execution on the material, non-public information which is what the federal securities laws were intended to prevent with insider trading rules, but it goes to actual communications, and that's something that really should be regulated very lightly, if at all.

THERESA GABALDON: Would you say that concern about that ever rose to the level of concern with the basic authority of the Commission to adopt it?

LAURA UNGER: Yes, and it's taken me six minutes to get into my tirade. I'm really trying to be very, very balanced. And I am balanced. Circumspect. Thank you. It's been a number of years. Yes, in fact, that was one of the first questions I asked because it is outside the normal rulemaking subject matter jurisdiction of the SEC because it does touch on communications and we the Commission did a fair amount of exploration with the Office of General Counsel about First Amendment issues and how Regulation FD would impact First Amendment and it was actually a very interesting process. I think in the final analysis, we determined that it would not materially impact the First Amendment and the rule itself does exempt the press from being liable or being responsible.

DIXIE JOHNSON: That was an important change between the proposed rule and the final rule - the scope of the recipients of this information and the number of people who would be caught up in the list of those who can violate the rule on behalf of the company.

THERESA GABALDON: As a practical matter, what do you think the affects of Reg FD have turned out to be?

DIXIE JOHNSON: Well from an issuer's perspective, the process of disclosing information to the public has become much more disciplined than it was before. Some companies, I think, have taken that discipline to result in less information being disclosed because of the risk that they could end up disclosing material, non-public information or be deemed to have done that when they didn't mean to in the first place and thereby violate Regulation FD if they didn't cure it within 24 hours. I think some companies are disclosing a lot and perhaps more than they would have before. I haven't seen any studies that really have been persuasive in reaching a conclusion either way.

LAURA UNGER: Well, you can come out in either direction, depending on who's undertaking the study, so I don't find studies particularly compelling in an anecdotal sort of setting, which I think a lot of what we're talking is anecdotal. It's intuitive. It's what CEOs tell you their practice is. It's what analysts tell you the information they now receive, the quality of the information they now receive. I've seen from my role as an independent director of several public that what Dixie describes is very true. The information flow is very scripted. It's not very spontaneous. If anyone asks questions and investment professionals ask questions in the context of flow of information, analyst conference, for example, or even something open to the public more generally, or for example, annual meeting. The response of the CEO is very scripted and they're very reluctant to say anything that might in any way be conceived of or construed of as a violation of Reg FD, and as Dixie points out, maybe this is a good thing.

DIXIE JOHNSON: Well in some cases, I think it may be. I think a little bit of discipline is not necessarily a bad thing, but I do think that all in all if the intent was to make more information available, or at least not restrict the flow of information, I question whether the intent has been achieved.

LAURA UNGER: I would say the information flow is clearly not coming from the company level to the analyst level in the traditional way it might have been. I shouldn't say clearly because there have been some enforcement cases, but for the most part, I think most responsible CEOs have curtailed their information flow. One of the side effects that people were championing as a positive impact of Reg FD has probably come to fruition and that is that analysts are doing a little bit more due diligence, because they don't have that direct line of access to company management about contracts or new products or things that the rest of the world wouldn't know about. They have been building on their mosaics by other means and so that's probably a positive impact.

DIXIE JOHNSON: One practical impact, for example, it used to be a normal practice for analysts to, or at least a frequent practice, perhaps not normal, for analysts to send copies of their draft reports to companies so that companies could comment on them before they were issued to the public. It was always the analysts' report, but if there were things that the company really disagreed with or thought could end up leaving a false impression with investors, the company would give feedback to the analyst. That's not something companies can feel comfortable doing now under Regulation FD.

LAURA UNGER: That was a slippery slope anyway because there was a real question of whether the issuer sort of adopting and having liability for the analysts' document, once they reviewed it and opined on it. That's probably just as well that that practice is discontinued, caveat emptor, if you're reading the analysts' report.

THERESA GABALDON: I was intrigued to hear you say that you felt that it was probably a positive thing for the analysts to be doing more due diligence. I suppose some people might say well, it's wasteful and duplicative and wouldn't it be better if there was just one single source of all the information and why not the source that happens to have the real scoop.

LAURA UNGER: Well, Theresa, you've hit upon probably the most important legal foundation of Reg FD, and that is the analysts' duty. To whom does the analyst owe a duty? Not the issuer, to the investing public, and a lot of that had gotten lost in the discussions about Regulation FD because it was such an exciting and groundbreaking approach to regulations, but really if you back up and say, I was going to say at the beginning, why this rule, why this way? How does it fit into securities laws regime, overall? Normally, you would have said if the issuer is passing on to the analysts material, non-public information and that analyst is passing it on to clients at the firm that analyst works for, and they're trading, you've got everything you need for a 10(b)5 violation, everything except the duty of the analyst to the issuer. And that's something that perhaps with case law could have been developed, but that's the sort of interesting rub in all of this is if the analyst had the duty to investors and not the issuer, if in fact they're going right to the issuer as their only pipeline as opposed to independently undertaking to gather information about that issuer, then query whether they're really fulfilling their duty to investors, and that's what I mean by a benefit.

THERESA GABALDON: I was somewhat curious about compliance structures and what issuers really do to make sure that they are in compliance and you've answered that certainly by telling me that they need to be scripted in their responses. They need to certainly have some notion of what their basic obligations are. I was wondering if they also had some sort of alert system when somebody knows, oops, I've said too much to an analyst. Does everybody at a company tend to know exactly what they need to do then for damage control?

DIXIE JOHNSON: Well, they tend to have procedures, issuers do, and they tend to have folks travel in packs so that they can keep an eye on each other, and when one is talking, another can listen. In fact, there's a recent enforcement case that came where the CEO and investor relations professional were traveling in a pair, but both of them were charged because the investor relations person knew the procedures and didn't stop the CEO from giving the information, according to the SEC document, in violation of the settlement.

LAURA UNGER: Well, there's a conflict right there, almost, is having the head of investor relations be the person who dictates where the parameters of Regulation FD are because it's in their best interest to have a good relationship with their investors, especially if they're big investors, that's usually what prompts a meeting with the CEO or senior management, so I think probably the better practice would be, even though I know we don't give advice, to have a member of the legal or compliance team with you who really is well-versed on the law, the interpretations of the law which have been on an ad hoc basis, I'm sure, depending on the situations.

DIXIE JOHNSON: And there may have been someone in that role at these meetings in that case, I'm not sure, but certainly people travel in packs now.

LAURA UNGER: Right, and it really is more difficult, as you point out to be on the road with your general counsel. That doesn't really make sense from a practical perspective.

THERESA GABALDON: That could be expensive, hanging out with the lawyers. Now I think we've been skirting around the issue of sanctions and enforcement actions and so forth. I know, Dixie, that you said earlier, well you haven't committed fraud if you violate it, but still you've done something naughty. What can happen to you?

DIXIE JOHNSON: Well, the penalties for Regulation FD violations are similar to penalties for other non-fraud based violations in the federal securities laws. The SEC has brought several enforcement cases alleging violations of Regulation FD, most of those have settled. At the beginning, first of all, the rule was in place for over two years, almost, yes, over two years before the first enforcement cases came out. Several of them were announced on the same day in November 2002 and the penalties ranged in those contexts, the sanctions ranged from a cease and desist proceeding that the issuers agreed to without admitting or denying violations, to in one case, a section 21(a) report of investigation. In that instance, the issuer, Motorola, according to the Commission, violated Regulation FD but they did it in good faith, relying on advice of their legal counsel that the information they released was not material and another end of the spectrum, a $250,000 penalty. That cluster of early cases then formed the basis for what has happened since. Since that time, one issuer has had the distinction of allegedly violating the provision twice, and being caught by the SEC. Siebel Systems is in litigation with the SEC over an alleged second violation. Another had a million dollar penalty and individuals have been penalized a $50,000 monetary penalty and then there has also been another case where the sanction was again just a cease and desist order that involved a very small company. So the sanctions have kind of been all over the board and can be very significant from a monetary perspective, but in any event, just the pain of an investigation is sanction enough to what to avoid.

LAURA UNGER: You certainly know the other side of that as well. Just to put a fine point on the rationale of the first cluster of cases was the regulation was adopted in August of

’00, that the Commission had promised not to bring any enforcement cases quickly and that they wanted to work with issuers and investment professionals to maybe further define or articulate what the objectives of the regulation were. And in fact at the time, I guess I was acting chairman in February of ’01, sometime in that time period we had a six month lookback on the rule itself, and a lot of feedback that I think was really helpful so this sort of cluster of cases, what had built up and was as much guidance to the industry as it was enforcement oriented and that was when the Commission was very fond of bringing several cases at the same time at once, and we called them sweeps. Three is not quite a sweep, but that sort of what was underlying that, exactly.

THERESA GABALDON: You mentioned, Dixie, I guess, that these companies had done it and had gotten caught. Do either of you have some view for how much communication might be going on undetected? You’re smiling.

DIXIE JOHNSON: Well, I don’t know how you measure that. I think that the Commission is investigating all the time a variety of levels of communication, and reaches a conclusion to bring an action only in, I guess by definition, a fraction of those instances, but I think there often are investigations of the potential for Reg FD violations that turn out not to end up being sanctions at all because the communication either wasn’t clearly material or they were made in good faith even if they weren’t perfect, or any of another, many numbers of mitigating circumstances can arise.

LAURA UNGER: I think you raised a great question Theresa, which is how does the SEC ever even find out about these cases? If you’re talking about a conversation between an issuer and an analyst, how would the enforcement staff find out? My belief and suspicion is that someone from Morgan Stanley finds out that someone from Goldman Sachs was in a one-on-one with an issuer, Siebel or something, and then in some sidebar conversation, hears about the information that was disclosed and turns in their competition. I can’t imagine how difficult it was be to actually monitor and regulate these conversations, which by their very definition occur in a very limited audience situation. Although they do happen as we’ve seen in broader situations, I don’t think there’s ever been an enforcement case involving an annual meeting. The larger situations I think is where you see the corrective filing. You have 24 hours if you mistakenly disclose information to correct that information by publicly disseminating it.

DIXIE JOHNSON: And those are all investigated, and then you determine whether it really was a mistake, that’s the purpose of that investigation.

LAURA UNGER: Right, but that doesn’t happen in a very small one-on-one meeting or anything. Probably the existence of these small investor conferences, or analyst conferences rather, are suspect.

DIXIE JOHNSON: Another way that they get at it is to look at the trading patterns and if there are patterns of fortuitous trades that occur around the time of surprising news developments that can prompt investigations both for the potential of insider trading which of course is fraudulent on one hand, and the likelihood of a tip, which is fraudulent or a Reg B violation which is not on the other.

LAURA UNGER: But where is that Reg FD violation with an insider trading counterpart? Haven’t seen it yet.

THERESA GABALDON: We’ll be talking about real-time disclosure, whatever that may be in a few minutes, and that may tell us something about the state of the art as far as determining what’s material and what isn’t, but short of that I’m curious to know if you think that issuers have sort of internal checkpoints, internal guideposts that help them with Reg FD to figure out what is material and what isn’t.

LAURA UNGER: Yes, my experience has been that CEOs know exactly what the investment community wants to know about the company and whether they see that as the definition of materiality and the context of the federal securities laws or not and they know what they need to tell the investment community to have analyst coverage or an analyst following and what they need to do in order to make their numbers, and when you drill down to again, they sort of genesis of all of this, it is the analyst, it is the issuer, it is the demand for information and what we haven't ever gotten to, even with the analyst conflict settlement and Reg FD and everything else is sort of a reform of that relationship and having the analyst in the position of still putting out consensus earnings forecasts, which drive a lot of the issuers to try to meet those numbers and that's when you see a lot of the conflicts, a lot of the shenanigans.

DIXIE JOHNSON: Well, and I think you do see there have been FD cases on giving interim guidance. That's what one of the most recent cases involved. Releasing information partway through the quarter that is, even if it's just reaffirming the guidance that had come out previously since time has passed and some real numbers are embedded in that reassurance, the Commission in that context is very likely to look at it, so if you have reports coming out that issuers have reaffirmed their guidance and that hasn't been on a widespread basis with full disclosure, then that's going to be something that's out too quickly.

LAURA UNGER: Issuers know exactly what analysts are basing their forecasts on. They know when there's been slippage or when those bases have been changed in their own mind, and what Dixie's describing is issuers managing expectations of Wall Street because the issuers will be punished if they miss their numbers, even by the analyst community, the investment community or the SEC.

THERESA GABALDON: The bottom line after, not several, but a few years of experience now with Regulation FD, would each of you say in retrospect that it has been a good thing or a bad thing?

LAURA UNGER: I think Dixie should go first.

DIXIE JOHNSON: I think that the discipline in disclosure that it has required is probably a good thing. I think it keeps things a lot more organized in communications and that avoids special favors and the kinds of risky behaviors that could occur on the fringes. Whether this was the way to it, I'm not so sure. On balance, I think that's been a good thing. I think the price that we've paid is that we don't have as much color on what's going on inside of companies, and sometimes that's really the information that when you put together a mosaic gives you valuable insight into a company that investors can find very useful.

LAURA UNGER: I think I would return to my earlier point which more troubling to me is the analysts driving the numbers with their forecasts and, for the public company issuers, trying to manage those expectations and for that sort of being a disconnect in terms of the communications and what Reg FD intends to accomplish. If there's insider trading, bring an insider trading case and test the duty and maybe expand the duty. The Commission's certainly done that before, so I think there's a more fundamental issue that Reg FD has not addressed, and my main concern is that it has impacted the flow of information and sort of created an unofficial parity of information contrary to the Supreme Court.

THERESA GABALDON: And it sounds then, Laura, as if you wouldn't miss it too much if it were to go away, and that may be particularly true now that we've got real-time disclosure, whatever that is.

LAURA UNGER: Yes, I do think that's true, but if you want to segue into the real-time disclosure notion or concept, how do you have real-time disclosure that's not spontaneous? Now, everything is in an SEC filing because you can't just talk without thinking and putting it into the total mix of information and knowing whether what you're saying is material given what other information is available in the marketplace without having sometime to really ponder that or consult with their lawyers or whatever. So I'd like real-time information. I think that's the way to go. The dissemination is probably somewhat troubling because it's not real-time information that flows out to the marketplace as a whole. It really still flows out to professionals first, most likely, who follow those developments.

THERESA GABALDON: I think that that is our segue to real-time disclosure. Dixie, could you explain to us what it is.

DIXIE JOHNSON: Well, we don't really have it, I guess, is the bottom line. Real-time disclosure would be investors getting information when company management does and that does not happen. I think it shouldn't happen. I think part of what we want companies to do and management to do is assess information and release it to the public in ways that are useful and valuable for investors. That's an imperfect process but I think it's important to know that we don't really have real-time disclosure. The phrase, I think, began when, after acting Chairman Unger stopped her tenure as acting Chairman and new Chairman Harvey Pitt came in to the Commission, one of the things that he was championing was real-time disclosure and real-time enforcement. The Sarbanes-Oxley Act, which came in to our laws the next summer in late July 2002, included a section that requires each issuer reporting under Section 13(a) or 15(d) of the '34 Act to disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English, which may include the trend, I'm reading as you can tell, trends and qualitative information and graphic presentations, and this is the important part, as the Commission determines by rule is necessary or useful for the protection of investors and in the public interest. The Commission has determined by rule that certain items that it has defined as material should be disclosed within a very quick time period. It's not real-time. It's within generally four days, but those are the new 8-K rules, and the new 8-K rules came out requiring companies in a number of different categories of circumstances to file what's known as a Form 8-K announcing that information to the public.

LAURA UNGER: Is it worth just taking a second to explain what 8-K was always intended to accomplish, which is for public company filers, which I'm sure filers under Section 13(a), I can't give you the exact numbers, but obviously they file annual reports and quarterly financial reports, for them to then provide intra-official filing information of a material nature, and there were a number of items that were deemed material to be disclosed in a Form 8-K, intra-quarter, intra-reporting period. And that's sort of what.

DIXIE JOHNSON: Right, and this list, the new 8-K rules expanded that list.

THERESA GABALDON: Exactly, substantially, and speeded it up a little.

LAURA UNGER: Well, it used to be ten days and in some instances as soon as practical which I think was interpreted as 24 hours, but that was limited to a very small number of the items that Dixie's alluding to, so four days is substantially shorter and the list is substantially expanded and not necessarily in plain English, but I'll let the real lawyer of the group.

DIXIE JOHNSON: Not once you try to parse it and of course the Commission staff has done a fair amount of work in trying to help people understand how they believe it should be interpreted, but until you get in the trenches with particular fact patterns and understand all the facts and circumstances regarding those fact patterns, it's not so easy to make these cuts and I think sometimes the Commission staff even now gets a little frustrated with people saying, but it's hard. They don't, if you get into the technical weeds and they interpret that sometimes as trying not to disclose rather than trying to get it right.

LAURA UNGER: Well for example, one of the new items is material definitive agreement, I think that's a new item. I, as a board member, I received a memo with these new 8-K requirements, and a very lengthy description of what a material definitive agreement and I could not deduce or repeat to you now exactly what that meant.

THERESA GABALDON: And you're an informed consumer.

LAURA UNGER: I thought so anyway. But, and of course I'm not the one necessarily making the initial cut as to what needs to be disclosed, but as a board member, you certainly need to be aware of what these requirements are as part of your responsibility, it's not necessarily intuitive and it depends. Each company's business is so different. What is a material definitive agreement to me may not be to the board Dixie sits on. So there's a lot of subjectivity to it and it's not necessarily a five percent rule or anything like that. But as with any new regulation, it will evolve into something over time with many interpretations and hopefully not too many enforcement actions.

DIXIE JOHNSON: We haven't had any, there haven't been, at least not that I've spotted, any new list Form 8-K violations, but I'm sure that someone will stumble at some point and I may have missed one.

LAURA UNGER: You know what's been interesting though, for me from a practical perspective is having information that needs to be required based on these new rules that triggers a Form 8-K disclosure, knowing that within a few days of that 8-K disclosure, you're going to disclosing something not necessarily different, but that would put the 8-K disclosure in a different context because you're filing your Q. And so having, being in the process of reviewing a Q, a quarterly report, or a K, an annual report, and having to disclose one of these new 8-K items before that is put into context I think could be one of those unintended results and a little bit anomalous and again the total mix of information in the marketplace. I'm sure that these rules aren't intended to create confusion or a smaller piece of the picture that you might get a few days later, but that's sort of one of those things that you wouldn't have necessarily thought of. It's been interesting. How do you deal with that?

DIXIE JOHNSON: That's right. Now for example this wouldn't occur in that context because she would probably have delays to the financial statements, but one of the items in the new list of 8-K is, if you have decided that you are going to restate your financial statements, you have to tell the public. It is a little startling that that wasn't a requirement before the new Form 8-K rules, but if a company concluded that the restatement really related to technical issues and errors that taken into consideration are not material or for other reasons concluded that even if it was material they didn't have enough obligation at the moment to disclose it, it wouldn't have had to be.

LAURA UNGER: I agree, and shocking as this may be, but sometimes the guidance changes or the regulatory interpretation of what's permissible changes and this is something else I've experienced where the Commission changes its position on what's is an allowable loan reserve, for example, and the company who's the beneficiary of that change of heart then has to go back and review their financial statements and might need to restate and it might not be, most likely would not be material, but as Dixie articulated, that's something that probably would not have been disclosed in the past. Now if there's a discussion with the auditor, now you have a conversation, the second the company is having a conversation where it seems substantially likely that they will be restating or there's a chance that they may be restating, you read about it in the paper and there's been a disclosure.

THERESA GABALDON: So we are seeing instances in which an issuer is announcing or filing an 8-K saying we think we're getting close to one of those things actually happening so we're filing now.

LAURA UNGER: And that's when you sort of question whether the total mix of information is so overwhelming that none of it means anything, and this happened when we first started getting information over the Internet and people would call it noise. You just couldn't filter through what's material, what's important to me, what would a reasonable investor want to know, it was "throw the bowl of spaghetti against the wall and see what sticks" kind of approach to disclosure, and I'm not criticizing this proposal by any shape or stretch of the imagination, but there is that point of diminishing return as you said, particularly when you consider our current environment where everyone is bending over backwards, as it were, to comply with every possible nuance of every regulation so as not to be the latest poster child for violating any new regulation. And so, especially when a new regulation comes to be, and especially in this kind of environment, people are probably tending to over-comply and you will get what you just described, Theresa, which is we're thinking about maybe, possibly talking to our auditors about restating, so here it is.

DIXIE JOHNSON: Well, we also are, there are items, this list that is part of the new 8-K rules, is a list of presumptively material items. Obviously there are things that can be material that aren't on this list.

THERESA GABALDON: What are they?

DIXIE JOHNSON: Well, let me tell you one that is not on the list that I find very interesting, and that is there's nothing on here that suggests that the fact that the SEC is investigating a company is something that the company needs to disclose.

LAURA UNGER: Never on the list.

DIXIE JOHNSON: It's not described as presumptively material, but Commission staff will tell you that all they have to have is official curiosity to begin an investigation and it is not, it is frequently the case, although certainly not by means always, that the Commission will look into something and decide that there's an enforcement action to be brought, and so the disclosure that one was underway, while accurate, could end up essentially causing alarm when no alarm needed to happen. Companies now, however, are more frequently disclosing when enforcement investigations are underway for a variety of reasons. One of those reasons, very practically is the scope of the document search that needs to occur and how many people need to be involved in the document search, how far it needs to reach and how likely it is once you've sought documents from that many people that information may leak out.

LAURA UNGER: It's a way to manage that information, so for the issuer to disclose it publicly that they're being investigated for XYZ rather than have it leak out, I think that's a very good point. But another anomalous thing about why the SEC doesn't come out and say you have to disclose that is because the existence of an investigation is not public so the SEC doesn't ever acknowledge the fact that there is an investigation and they won't, so they can't on the other hand require that public companies do disclose when they themselves will not.

DIXIE JOHNSON: Well I think they also have not concluded that it's material. It would be a fact of circumstances analysis and usually the analysis goes to whether underlying violations have occurred that may be material whether the cost of the investigation to the company will result in a material charge, whether the penalties that they're likely to face could be material to the company. Those kinds of things are where the real analysis is, the analysis of whether there's an investigation in fact is generally not the thing that tips people over the edge in a disclosure context.

LAURA UNGER: And not to belabor the point, but I think that's absolutely right. You don't ever see companies that have been merged, or in a merger acquisition context, oh, and we're being investigated by the SEC. Everyone knows that that's fairly routine. Every merger and acquisition pre-trading is investigated the NASD and the SEC depending on the level of trading activity and that's exactly right.

DIXIE JOHNSON: Or the New York Stock Exchange.

LAURA UNGER: Good counsel will be able to appreciate that and give good guidance as Dixie so obviously can, but I think it's also a function of the plaintiffs' bar if you want to get that information out there if it is going to be material. Of course that always gives them ideas, so it's a double-edged sword, but in any case.

THERESA GABALDON: Do you think that the items are listed as requiring 8-K disclosure now represent an attempt to limit the sphere to those things that really are fairly definite things that have happened as opposed to things that are just in process?

DIXIE JOHNSON: I think that was the intent. The effort, and you can see the transition again between the proposed and final rule, this is another example of where the comment process is very important. You see a significantly more particularity in the context of the final rules to address issues brought up in the comment process and I think most of those changes moved things into the direction of definable events.

LAURA UNGER: I would back up and look at the whole underlying reason for this requirement in Sarbanes-Oxley, which is that there was a sense in the post-corporate meltdown environment that there was a lot of information out there that reasonable investors would have wanted to know about Enron, WorldCom, Adelphia, Tyco, you name it, and they weren't getting that information and point in fact, when they drilled down a little bit more there was no requirement for that information to be disclosed. The whole idea was to provide more transparency in the marketplace which is one of the main objectives of Sarbanes-Oxley. So I would not be surprised if you went back and really drilled down even further into what people thought should have been out in the public with all of those tragedies, as it were, you would find some of the exact items on this list that were not disclosed.

DIXIE JOHNSON: And Laura is exactly right. A prime example of that is Rule 504, pension plan blackout periods, which was a big Enron issue, many other examples.

LAURA UNGER: And of course, the SEC also uses disclosure as a form of behavior modification, so one of the items is a code of ethics. And if you don't have a code of ethics, you need to disclose why I think is my recollection of how that goes.

DIXIE JOHNSON: Right, and if you have departed from the code of ethics, if you've taken exception from the code of ethics, that's also relevant in the disclosure.

LAURA UNGER: That goes right to the Enron waiver of the conflicts transaction without getting into the transaction.

THERESA GABALDON: Well, I have two related questions. One is whether, Laura, you said earlier that you thought maybe Regulation FD had gone a little too far. Do you think that the SEC has complied with the Congressional mandate of Sarbanes-Oxley and doing what it's done thus far and then would having these rules in effect have prevented Enron?

LAURA UNGER: Well, which one should I start with? I think the SEC has endeavored to really take a hard look at what would be material events within the existing quarterly reporting periods that investors would want to know that would be immaterial to a company's performance or again what a reasonable investor would want to know, and stuck to very concrete items as you disclosed. There's always a catchall and you have to disclose anything material. I think there's that notion that a good corporate citizen or company will always disclose material information and make it available in the marketplace, even if it's not through an 8-K or a 10-K or 10-Q. So that being said, I don't think, the big myth is that the SEC and Eliot Spitzer can prevent fraud. That's just not possible. If somebody wants to commit fraud and they have willing co-conspirators or people who are willing to look the other way, fraud will continue to occur. There is nothing in this world that will make fraud go away. What you can do is make it really unappealing and what Sarbanes-Oxley does is make it really unappealing. They put in many layers of protections. The gatekeepers who were all asleep in the Enron situation, the boards of directors, the lawyers, the auditors, now have a lot more obligation. Really compelling is the potential jail time which has been expanded dramatically to 25 years in some cases, and they've added a number of other requirements and/or obligations that I think make it a lot more unattractive to commit fraud and that's really the most you can do and as you have more transparency, as you have more accountability and as you have more integrity generally, then you hopefully will have an environment where less fraud is committed by people that have enormous impact on the marketplace.

THERESA GABALDON: Dixie, what's your take on that, what the SEC has done to comply adequately with that language that you read earlier?

DIXIE JOHNSON: Well, I think it does because it, the Congress, I think, clearly intended to leave in the Commission's hand the opportunity and the responsibility of determining what the rules ought to look like in order to achieve this purpose where the Commission felt it was important to achieve. I don't think there is or should be a risk of someone being sued under Sarbanes-Oxley who complies with the SEC's rules, but somehow doesn't seem to have disclosed rapidly and currently certain information. I think there's not a risk of that really flying in a court of law because the statute clearly says the restrictions really have to be described and promulgated by the Commission itself. I do think though it would be easy for the Commission just to not pass a rule and that might have complied with this as well, arguably. Obviously the Commission didn't do that and they took seriously the mandate to find ways to increase the information flow items they believe ought to be disclosed more frequently than in the quarterly reports or at a time of securities offering. And that's how we ended up where we are. I agree with Laura. If people want to commit fraud, they're going to find a way to do it. But we have made it, I think, Congress has, and the people who work diligently in the trenches with companies have made it a lot harder. The processes that are in place and the hoops that someone would have to jump through are significantly harder and the penalties are significantly higher, so hopefully the frauds will be fewer and farther between. The risk is, as is always the case and that's why some of us do what we do, the risk is that behavior that isn't fraudulent will be, in hindsight, viewed that way and that's what we have to guard against, too.

THERESA GABALDON: You said earlier, and I think it was Laura, that there's a notion of good corporate citizenship and you should disclose material things, but would you each agree that there is at present no general free-floating duty of affirmative disclosure, that if there isn't something that's specifically called for by rule and no need to update or correct something?

LAURA UNGER: No, that's correct. Your only duty is if you intend to trade, if you have an issuer or somebody that has a fiduciary obligation to the issuer, an insider has material, non-public information. The only duty to disclose that information is if they want to trade. So the duty is either abstain from trading and not disclose, or disclose and trade.

THERESA GABALDON: Do you think that the new rules could even be helpful in shaping an argument that, well, this thing that happened wasn't on the list so why should we have had to disclose it?

DIXIE JOHNSON: I think it will be helpful because the list presents a guide of things that are presumptively material. I do think though that the Commission in passing the rule was very clear to say that this isn't the universe of material, non-public information.

LAURA UNGER: It is amazing they didn't put in a catchall provision. I just had to take a second look, and it said or anything else.

DIXIE JOHNSON: No, they didn't. They really kept it very defined and I think that does leave open the possibility that there may be circumstances where people will look at the checklist as a checklist, and the risk is that they would forget to evaluate whether they separately from that have material, non-public information that would preclude them from trading. It may not be required to be disclosed, but it could preclude them from trading without disclosure.

LAURA UNGER: Right, and certainly the SEC could in time add to this list. They could change what is a reasonable, what's the exact language here, the time period in which you have to make the disclosure, four days doesn't seem practical for some things. As I've said before, there are different time periods for different disclosures under the old 8-K rules, so that you could see some sort of fiddling with the rule, but I wouldn't necessarily expect it. I don't hear a lot of outcry over this rule other than trying to understand it and incorporate it into the existing disclosure regime.

THERESA GABALDON: So you don't hear people saying we're being forced to disclose too much?

LAURA UNGER: No, people are really focused on Sarbanes-Oxley Section 404. They are just not talking about the 8-K requirements, shockingly. When you compare millions and millions of dollars and most of your disposable staff working on Section 404 internal controls compliance, Form 8-K disclosure requirements kind of pale in comparison.

DIXIE JOHNSON: I think a lot of companies though are struggling with whether to deal with 8-K in the context of disclosure committees or outside the context of that whether to have a subcommittee of their disclosure committees deal with this potentially ongoing disclosure obligation and convene the disclosure committee only for the quarterlies. I think companies are struggling with how to manage it, but it is among a smaller set of people, as Laura has indicated, there are other things that are impacting many, many people throughout public companies. This 8-K requirement should impact a smaller set of people. Now with that said, that smaller set of people is sitting there dealing with a disclosure issue that could involve information that rests more broadly within a company.

THERESA GABALDON: Exactly, you can't disclose what you don't know, and people have to know to tell you about these things.

DIXIE JOHNSON: So they have people to do that.

LAURA UNGER: Good corporate governance guidelines all suggest that public companies have a disclosure committee that meet regularly, and I guess that depends on the company, but I think most people consider that to be bimonthly at least, even in a short meeting.

THERESA GABALDON: And I would assume they decide whether there's a material contract that has to be disclosed but somebody has to be in the contracts department or wherever.

LAURA UNGER: Well, what happens is, again as I said earlier, it depends on the nature of the business of the company. It's really the initial cut that most of these businesses need to make. I'm in the widget making business. Does each of my service provider contracts need to be disclosed? Once they make that initial cut as to where, given their ordinary business procedures, they need to be making ongoing disclosures, then I think the other new novel ideas that come up are a little bit farther and farther between.

THERESA GABALDON: That makes sense. Now we've been talking a lot about materiality today, and obviously materiality is in the eye of the beholder, sometimes, in the eye of the reasonable investor, that being the touchstone for the definition of materiality, but some of the items that are on the 8-K list raise real questions in my mind. First is I think one of the things on the list is disclosure of material impairment of assets. How do you know when an asset has been materially impaired?

DIXIE JOHNSON: That's a GAAP question, and not the Gap where you buy jeans, a detailed GAAP question, and it's governed by a lot of accounting literature, and the reason it's on the list is that a material impairment can take the value of an asset that's carried on the books to zero, or to another number that is significantly different from where it is on the books with, in some instances, kind of a minor change in the marketplace, and so it is one that you would want your auditors and people who are much more in tune in analyzing those issues to be involved in. You don't want just lawyers looking at the issue.

LAURA UNGER: But that's probably why a disclosure committee would convene on a regular basis and I would expect that someone from at least internal audit would be a member of that committee. It couldn't just be the lawyers sitting together. It would have to be business people too.

THERESA GABALDON: Well, I'd be interested in hearing from each of you about what your bottom line is on the state of disclosure today. Do we have too much, too little? Are the rules too hard to understand? Is it a masterpiece in progress? What's the bottom line?

DIXIE JOHNSON: I think we have a lot of process. I'm not sure that the quality of information out there is significantly better than it was a few years ago. I think that it's getting there. Really, one of the most effective means of increasing disclosure, I think, is increasing the review process the Division of Corporation Finance does issuer by issuer, item by item, saying more needs to come out on this. Please tell us more. And the other aspect is the disclosure lawyers that are out there working in the trenches helping their clients conclude how to get more information out and when it's important to get more information out to the public. With that said, you know, as Laura said earlier, we live in an information age where there is a great deal of information out there, and sifting through it to determine what really matters is quite a challenge, and I think that the real art to disclosure is sending an accurate consolidated picture of what's happening in a company out to investors, and that's where everybody is struggling.

LAURA UNGER: I was talking to Dixie about this issue on the way over, and I'm very intrigued by the SEC's considering the concept of layered disclosure, which would start at the first level on the Internet with very simplified disclosure and enable investors to really drill down in what their interested in. A concept like that is long overdue and I think would be every useful to letting reasonable investors decide what is material to them.

THERESA GABALDON: Our time is up and I would like to thank both Dixie and Laura for today's very informative discussion. I'd also like to remind our audience that the Fireside Chat is now archived by audiotape in the Society's virtual museum. The transcript of the chat will be ready soon. I'll be returning as moderator next month for the Best of NERA II, a program of some of the key discussion from NERA Economic Consulting's annual Finance, Law and Economic Securities Litigation seminar. Please join us on Wednesday, July 27th at 2 PM Eastern Daylight Savings Time. Our Fireside Chats will resume in September with a discussion on cross-border regulation. Our panelists will be Louis Bevilacqua, partner with Thelen, Reid & Priest, and Richard Booth, Professor of Law, University of Maryland School of Law. Please join us on Tuesday, September 20th at 3 PM Eastern Daylight Savings Time. Thank you for being with us today.