REGULATION FD AND PRIVATE TRADING ON THE INTERNET: KEEPING PACE WITH CONSTANT CHANGE

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The current situation in the securities industry reminds me of a quote by Mr. Spock on *Star Trek*. Although Mr. Spock is not ordinarily an accepted authority on legal issues, he once stated that "[c]hange is the essential process of all existence," and what we are seeing right now is change at light speed.[1] What we were seeing, at least in the days of the stock market's boom, was a dramatic increase in the prevalence of online trading.[2] The regulators are beginning to deal with how the Internet has increased the already rapid flow of information to everybody involved in the securities industry. It is a very unsettling situation right now, but it will also create a lot of new opportunities that will change the way we live and do business.

For instance, everyone now practicing in this area needs to be able to access the SEC's FreeEDGAR.com Web site because all of the important and relevant information, including all of the major SEC filings, is there. As a result of the Web site, getting that information is far easier than it used to be.[3] The SEC had great foresight when it decided, quite a few years ago, to go to EDGAR online as their primary method of distributing information, despite the fact that many people probably asked, as I certainly did, "Why are they doing this?" What has occurred is that now you have many different people sitting

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1. *Star Trek: Let That Be Your Last Battlefield* (NBC television broadcast, Jan. 10, 1969).

2. *See Individuals' Thirst for Internet Stocks Boosts Online Brokers*, L.A. TIMES, Dec. 22, 1998, at C7 ("Individual investors, spurred by hunger for Internet-related stocks, have increased online trading at least 30% just since last September, industry executives say.").

3. http://www.freeedgar.com (Web site operated by private company Edgar Online that provides access to SEC documents, initial public offering information, annual reports, and stock quotes, as well as wide variety of other information, at no charge).

at desks, making trading decisions, because they are able to access the information at the same time that everyone else can. This situation is very different from the past, when information was much harder to come by, and was accessed quickly only by securities professionals.

One of the results of these changes spurred by the Internet is Regulation FD, which took effect in the Fall of 2000.[4] Regulation FD attempts to level the playing field by ensuring that information is available to all interested parties on an equal-access basis. In the old days, the analyst played a very important role in obtaining material non-public information from corporations, and then deciding how it was going to be disclosed to the public. Supreme Court cases and other major cases discussed the important role of analysts.[5] But, as everybody knows, analysts can make mistakes or do things for their own personal benefit. For instance, the SEC has noticed that right before material non-public information has been disclosed to the general public, incredible increases in trading "coincidentally" have occurred.[6] So the SEC, after a fairly hard fought process, finally decided to promulgate Regulation FD, which provides a fair way of ensuring disclosure to all people who would be interested in the information.[7] Under Regulation FD, publicly held companies must provide important, non-public information to the public at the same time that securities analysts and other market professionals obtain this information.[8] Additionally, if information is inadvertently disclosed to individuals prior to its public disclosure, then the company is required to release the information to the general public by press release, a Form 8-K, or some other mode of general dissemination within twenty-four hours of

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4. Regulation FD, 17 C.F.R. § 243 (2001).

5. *See, e.g*., Dirks v. SEC, 463 U.S. 646, 658–59 (1983) ("[I]nformation that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities."); State Teachers Ret. Bd. v. Fluor Corp., 592 F. Supp. 592, 594 (S.D.N.Y. 1984) (market analysts' "inquiries are 'necessary to the preservation of a healthy market'" (quoting *Dirks*, 463 U.S. at 658)); *see also* Brief of Amicus Curiae Ass'n for Inv. Mgmt. & Research, United States v. O'Hagan, 521 U.S. 642 (1997) (No. 96-842) (containing extensive section discussing how analysts play vital role in efficient functioning of market).

6. *See* Howard Groedel, *SEC Looks to Tighten Rules for Fair Disclosure*, CRAIN'S CLEVELAND BUS., Mar. 27, 2000, at 29 ("Indeed, several studies have demonstrated that trading volume and stock price volatility in a company's stock notably increases during and immediately after that company's analyst conference calls.").

7. *See* Fred Barbash, *The Earthquake That Didn't Happen*, WASH. POST, Apr. 22, 2001, at H1 ("Many leaders of the securities industry, who had opposed Regulation FD and still do, predicted the worst."); John Labate & Andrew Hill, *SEC Has Companies' Disclosure of Information Firmly Within Its Sights*, FIN. TIMES, Aug. 9, 2000, at 9 ("The issue [of Regulation FD] has triggered a public outpouring unmatched in the recent history of securities regulation.").

8. 17 C.F.R. § 243.100(a).

the inadvertent release.[9] The goal of the regulation is to level the playing field so that all people, regardless of whether they are at a desk in a securities firm, at home, trading online, or somewhere else entirely, can obtain the information and trade based on that information at about the same time as everybody else is able to do so.

Regulation FD does not provide for a private right of action, so individuals injured by a violation of Regulation FD do not have a right to sue the issuer. Under Regulation FD, only the SEC has the right to bring an enforcement proceeding. While it took a while for them to do so, the SEC has already begun to investigate potential violations by some well-known companies, including Raytheon and Motorola, although no actual charges have been filed against any company as of now.[10]

Under Regulation FD and traditional practice, there are a bunch of "dos and don'ts" that practitioners should try to adhere to when dealing with conference calls, analyst conference calls, reports, meetings, and other similar activities that distribute information about securities to people. One of the things to remember in organizing these activities is to try to get as many people as practicable involved in the dissemination of information, through a Webcast, a conference call, or some other means. Current technology makes it easy for an analyst or anyone else to dial in and listen to the conversation or ask questions that everyone can hear.[11]

In order to comply with SEC requirements, a company needs to provide advance notice of a date, time, and means of access to the conference calls. The company must also issue a related press release at least two or three hours in advance of the conference call so that people at least know what will be discussed and can ask questions. Additionally, a company has to make sure that the people who are involved in the conference call know what the topic is, so they think through the questions and answers beforehand. Finally, the conference call should be as accessible to the general public as possible. The call should be Webcast, if possible, and made available via the

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9. *Id.* § 243.100(a)(2) (requiring that disclosure be made "promptly"); *id.* § 243.101(d) (defining "promptly" as "as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange)").

10. Neil Roland, *SEC Warns Companies of Disclosure Limits*, WASH. POST, June 1, 2001, at E2.

11. *See* Carol Vinzant, *Keeping an Ear on Wall St.*, WASH. POST, June 14, 2001, at E1 (discussing how Webcasts have become both more commonly used by companies and more often viewed by investors as result of Regulation FD and other changes in securities industry brought about by rise of Internet).

Internet for two or three days thereafter so that those who were unable to attend the event can still have access to the information. The media should have access to the call, and written materials distributed to participants should be available to the public and the media on the company's Web site after the call. All of these efforts attempt to ensure that the information is disclosed to everyone who needs to know it and that Regulation FD is not violated.

Of course, there are actions that companies should make every effort to avoid as well. For instance, a company should not provide information to particular market analysts, shareholders, or investors on a one-to-one basis late in the quarter, immediately before the earnings are going to be publicized. As everybody now knows, there are "first call" expectations followed by "whisper numbers," and people have an expectation that if the actual earnings number goes above the expected earnings number, the stock will benefit. Conversely, if the number is below expectations, the stock's performance will be poor. Regulation FD has caused a big stir in the investment community, and it is something that all practitioners ought to be aware of.[12] Although there is no private right of action, the SEC is ready to impose penalties on those who disclose information in violation of the provisions of Regulation FD.[13]

In May 1999, then-SEC-Chairman Arthur Levitt gave a speech at the National Press Club that made clear that he and the SEC wanted to make brokers aware that they still have the same obligations to customers whether the customers invest through online trading or by using the telephone.[14] Former Chairman Levitt also tried to show that there are many misconceptions about online investing. He pointed out that people really do not have a direct connection to the securities market, no matter what they think when they go online and make, or try to make, their trades.[15] Many people still think that when they click on the "make trade" button they have already made the trade.

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12. *See, e.g.*, Cheryl Winokur Munk, *SEC Disclosure Rule Dims Appeal of Conferences*, WALL ST. J., Feb. 27, 2001, at C16 (reporting that Regulation FD's strict information-sharing rules have made investment conferences less useful to investment firms); Jeff D. Opdyke, *The Big Chill: Street Feels Effect of 'Fair Disclosure' Rule*, WALL ST. J., Oct. 23, 2000, at C1 (reporting that Regulation FD limits information available to analysts); *see also* sources cited *supra* note 7.

13. *See* 17 C.F.R. § 243 (providing no private right of action in cases of violations of Regulation FD); *see also* sources cited *supra* note 10 (discussing SEC actions to enforce Regulation FD).

14. SEC Chairman Arthur Levitt, Plain Talk About On-Line Investing, Address at the National Press Club (May 4, 1999), *at* http://www.sec.gov/news/speech/speecharchive/1999/spch274.htm.

15. *Id.*

But the trades first go into a computer, then into a broker's mechanisms for making the trade. Sometimes these mechanisms clog and back up, systems break, and orders can be delayed. For example, several times in 1999, E-Trade's entire system broke down, stopping trades from going through, losing business, and upsetting customers who did not get to purchase stock at the time and price they intended.[16] This was a particularly serious problem in a market in which regular stocks might fluctuate in value by five to ten percent over the course of a single day, as was true in 1999.

Another misconception people have about online trading is that they will be purchasing at the market price when they click the order button. Former Chairman Levitt also correctly pointed out that, if possible, it is best to try to use limit orders so that investors can buy or sell securities at a specific price in order to avoid these problems. In a limit order, the purchase of a stock can only be completed when the price is at or below a certain number. Especially in the initial public offering (IPO) markets of 1999, the market was running away from people. Investors could not get into an IPO at the start of trading, and a couple of hours later, when they finally could get into the IPO, its price could have doubled or increased even further than that.[17] Sometimes, when people thought they were buying a particular stock at a particular price, they were actually buying it at a price that was double or even triple that number. This resulted in a large number of upset purchasers.

Another misconception about online trading is that when a trader wants to cancel an order, he or she can cancel it just by hitting the cancel button on the screen. However, the cancel has to be received by the individual broker handling the order before the order is actually cancelled, which sometimes leads to trades being made that investors may not have wanted to make. An even more significant misconception is that an investor will be notified in advance in the event of a margin call. This is not the case. If a broker needs cash in order to cover a margin call they are not required to notify the trader. The broker has the right to go ahead and sell securities to cover the trade

16. *Digest*, WASH. POST, Feb. 5, 1999, at E1; *Glitch Disrupts E-Trade for Third Time in Three Days*, L.A. TIMES, Feb. 6, 1999, at C3.

17. *See, e.g.*, Cassell Bryan-Low, *A Little Progress: Internet Gives Small Investors a Better Shot in the Race for IPOs*, CHI. TRIB., Sept. 14, 2000, at C1 (discussing "IPOs that register triple-digit moon shots—such as Blue Martini's 174 percent first-day rocket"); Debora Vrana, *Success in Pricing IPOs Is Measured in Different Ways*, L.A. TIMES, Nov. 23, 1998, at C1 (discussing various IPOs that gained two hundred percent or more on their first day of trading).

without having to make the trader aware of the margin call until after the securities are sold.[18]

The Internet has also transformed securities exchanges by creating an after-hours market. It used to be that companies would issue press releases during the business day because that was when people did business. Now, when companies have earnings releases, they are made at the close of business. Consequently, in some of the after-hours markets on the Internet, there will be incredible fluctuations in trading. A stock may have closed at sixty and suddenly, at 5:00 P.M. in the East, the stock will have a price of seventy.[19] Former Chairman Levitt was quick to point out that there is a smaller number of people in the after-hours market than in the regular trading market, so a lower volume of trading can create much greater variations in a stock's price than could happen with the same volume of trading during the regular trading day.

In light of all these issues raised by former Chairman Levitt, the only way you can really keep up with what is going on in this area is to be online constantly. This is evidenced by the fact that the *NYSE Listed Company Manual*, which most securities professionals who deal with the New York Stock Exchange use, is no longer being kept up-to-date in paper form. It is now only available online.[20] These online connections enable people to determine what is changing and get the most up-to-date information. Doing legal research used to mean looking at the pocket part, but that has changed. Now it means going online to make sure that nothing has changed from earlier that day, because of the rate of change going on in the law, especially in the securities industry.

Due to the rapid changes in the law, the National Association of Securities Dealers (NASD) announced a new rule, Rule 2361, which

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18. NAT'L ASS'N OF SEC. DEALERS, CONDUCT RULES R. 2520, at 44, http://www.sec.gov/pdf/nasd1/2000ser.pdf. The NASD has recently taken steps to remedy the lack of information available to traders by approving NASD's proposed Rule 2341, which would require that a margin disclosure statement be sent to investors making clear that, in the event of a margin call, a broker may sell an investor's securities or other assets without first contacting him or her. *See* Self-Regulatory Organizations, Securities Act Release No. 34-44223, 66 Fed. Reg. 22,274 (May 3, 2001) (granting SEC approval to NASD's proposed changes requiring that investors be told that they need to be told about margin calls).

19. *See, e.g.*, Dave Kansas, *Nicked at Night: Even After the Market Closes, Stock Prices Can Take Wild Swings*, WALL ST. J., Sept. 12, 1996, at A1 (discussing how after-hours markets have affected trading patterns on New York Stock Exchange and elsewhere).

20. The *NYSE Listed Company Manual* is now available on the World Wide Web at http://www.nyse.com/listed/listed.html.

requires that a day-trading risk disclosure statement be given out by any brokerage firm that promotes a "day-trading" strategy.[21] Under this rule, any broker promoting a day-trading strategy has to provide all investors a statement stating that day-trading can be extremely risky and that investors must be cautious of claims of large profits from day-trading. The concept of people making enormous fortunes from day-trading and online trading has caused a California gold rush mentality.[22] Although people were not aware of the risks during the market boom, people have become more aware of this risk in the last few years—what goes up sometimes comes down, and sometimes comes down even more quickly than it went up.[23]

The central lesson of the Internet in the securities market is that every time you think you have seen it all, you have not. Things are changing at such light speed in the practice areas that not that long ago there was a foreign exchange that was operating a Web site and wanted to ensure that their Web site was not violating the U.S. securities laws. The only way we could really see what was going on and what other exchanges were doing was to look at other exchange Web sites, and look at how they took measures to ensure they were in compliance with the United States' securities laws.[24] Things are changing at such light speed in the securities industry that everyone has to be aware that no one can really understand everything about how quickly the system is changing—not even Mr. Spock.

21. NASD, *supra* note 18, R. 2360, APPROVAL PROCEDURES FOR DAY-TRADING ACCOUNTS. NASD Rule 2360 defines a "day-trading strategy" as "an overall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities." *Id.*

22. *See, e.g.*, Ianthe Jeanne Dugan, *At Day-Trading Firms, Amateurs Keep Eyes on the Price*, WASH. POST, July 30, 1999, at A16 (noting that "thousands of amateurs" are "flocking to day-trading firms that offered promises of riches and independence").

23. For example, the NASDAQ rose over 1100 points between August of 1999 and August of 2000, and then fell by more than 1800 points by August of 2001. *See* N.Y. TIMES, Aug. 3, 1999, at C13 (reflecting close for the NASDAQ composite of 2,623.63 on August 2, 1999); N.Y. TIMES, Aug. 1, 2000, at C15 (reflecting close for NASDAQ composite of 3,766 on July 31, 2000); N.Y. TIMES, Aug. 16, 2001, at C7 (reflecting close of 1,918.89 for NASDAQ composite on August 1, 2001).

24. For examples of such Web site disclaimers, see, e.g., the Web site of the New York Stock Exchange, at http://www.nyse.com/home/copyright.html; the Web site of the American Stock Exchange, at http://www.amex.com/sitespecific/IndexPromptDisclaimer.stm#disclaimer; the Web site of NASDAQ, at http://www.nasdaq.com/site specific/IndexPromptDisclaimer.stm#disclaimer.