RETHINKING REGULATION FAIR DISCLOSURE AND CORPORATE FREE SPEECH

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In a significant departure from the disclosure regime created by the insider trading rules of the Securities and Exchange Act of 1934 (Exchange Act), Regulation Fair Disclosure (Reg FD) forces publicly traded companies to make simultaneous public disclosure of any information they make available to analysts or institutional investors. The rule gives issuers a choice: make public disclosure or don't disclose to anyone. Reg FD targets the transmission of information, rather than any actual trading based on that information. Unlike the insider trading rules, Reg FD is not an anti-fraud provision and the government can assert a claim without establishing any deceptive conduct or breach of any fiduciary duty.

The Securities and Exchange Commission (SEC) adopted Reg FD to compensate for the perceived ineffectiveness of insider trading laws. Case law that has developed since the adoption of Reg FD establishes that the perception was unfounded. Reg FD no longer serves an important function in light of the current judiciary's expansive view of insider trading restrictions, the government's success in prosecuting expert network firms, and the government's ability to use novel investigatory techniques.

Moreover, because it restricts the transmission of truthful information, Reg FD is also problematic from a First Amendment perspective. The Court has recently held that speech restrictions cannot be justified simply because they apply to a heavily regulated area, such as securities laws. If challenged under the commercial speech doctrine, the broad prophylactic restrictions on an issuer's ability to disclose information to analysts or institutional investors would unlikely withstand First Amendment scrutiny. Further, if

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This Article does not consider the impact that the Second Circuit's opinion in *United States v. Newman* would have on the analysis of insider trading liability, as it was handed down just before this Article went to press. Nos. 13–1837–cr (L), 13–1917–cr (con), 2014 WL 6911278 (2d Cir. Dec. 10, 2014). It is unclear whether this decision will be reconsidered en banc.

measured against the robust articulation of corporate political speech rights in Citizens United v. FEC*, Reg FD fails miserably.*

Rather than focusing on the selective disclosure by issuers and providing equal access to all investors, the SEC should refocus on the real problem of trading. Vigorous enforcement of Section 10(b) and Rule 10b-5 should provide adequate protection to investors, and should do so without restricting private speech or compelling public speech.

TABLE OF CONTENTS

INTRODUCTION

At the turn of the century, the Securities and Exchange Commission (SEC) enacted Regulation Fair Disclosure (Reg FD) to prevent selective disclosure by public companies to analysts and institutional investors.[1] The regulation requires issuers to make public disclosure of any information they make available to certain individuals or entities—generally, securities market professionals, or influential stockholders.[2] Issuers must make that public disclosure "simultaneously" with the selective disclosure in the case of intentional disclosure and "promptly" in the case of inadvertent disclosure.[3] Although the SEC promulgated Reg FD to plug perceived loopholes in the insider trading laws, Reg FD does not directly target insider trading.[4] Instead, Reg FD targets the transmission of information, not actual trading based on that information.[5]

Reg FD's restriction on the free flow of accurate information is both problematic and unnecessary in light of the current state of insider trading law. Consider the case against Rajat Gupta, a former Goldman Sachs director.[6] Gupta leaked boardroom secrets to his friend and

1 See *infra* Part I for a description of Reg FD.

2 17 C.F.R. §§ 243.100–243.103 (2011). The SEC initially proposed Reg FD in December 1999. Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,592 (proposed Dec. 28, 1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, 249) [hereinafter SEC Initial Reg FD Proposal].

3 17 C.F.R. § 243.100.

4 *See* SEC Initial Reg FD Proposal, *supra* note 2 (explaining that since selective disclosure is different than insider trading, it can be regulated by means other than the anti-fraud provisions of Section 10(b) and Rule 10b-5).

5 Letter from Lee Spencer, Jr., Chairman, Ad Hoc Working Grp. on Proposed Reg FD, and George Schieren, Vice President of Compliance and Legal Div., Sec. Indus. Ass'n, to Jonathan Katz, Sec'y, SEC (Apr. 6, 2000) (on file with the SEC), *available at* http://ftp.sec.gov/rules/proposed/s73199/spencer1.htm.

6 Rajat Gupta also ran the consulting firm McKinsey & Co. and served on the board of Procter & Gamble (P&G). Gupta was also a major adviser to the philanthropic efforts of Bill Gates and Bill Clinton. *See* SEC v. Gupta, No. 11 Civ. 7566 (JSR), 2013 WL 3784138 (S.D.N.Y. July 17, 2013).

business associate Raj Rajaratnam,[7] the former head of the Galleon Group hedge fund.[8] Circumstantial evidence established that Gupta participated in a Goldman board call during the financial crisis in which he learned that Warren Buffett of Berkshire Hathaway would be making a five-billion-dollar investment in the firm.[9] Immediately after the board call, Gupta called Rajaratnam.[10] Within one minute of that call and a few minutes before the market closed, Rajaratnam directed the Galleon funds to purchase more than 215,000 Goldman shares.[11] After the investment was publicly disclosed, the Galleon funds liquidated their Goldman holdings, making illicit profits of more than $800,000.[12]

The evidence further established that Gupta disclosed Goldman's financial results for several quarters before they were publicly released. Specifically, there were several calls between Gupta and Rajaratnam hours after Gupta learned from Goldman's CEO that the firm's results for the second quarter of 2008 were significantly better than analyst consensus estimates. The following morning, as soon as the markets opened, Rajaratnam caused Galleon funds to purchase Goldman shares. Rajaratnam liquidated these shares when Goldman announced its quarterly earnings—generating illicit profits and loss avoidance of more than $23 million for the Galleon funds.[13]

Although Gupta himself did not make any trades based on inside information, he was convicted of insider trading for passing the information along to Rajaratnam, who directed his funds to purchase or

7 Rajaratnam cultivated friendships with corporate insiders, law firms, banks, and consulting firms. Through these relationships Rajaratnam received nonpublic information, which he then used to make trades and receive millions of dollars in profits by engaging in insider trading as a tippee. *See* United States v. Rajaratnam, 802 F. Supp. 2d 491, 499–501 (S.D.N.Y. 2011). Ultimately, Rajaratnam was found guilty of insider trading as a tippee and was sentenced to eleven years in prison—the longest sentence to be imposed for insider trading—and ordered to pay forfeiture of $53.8 million, a $10 million criminal fine, and a $92.8 million civil fine. *See* Press Release, SEC, SEC Obtains Record $92.8 Million Penalty Against Raj Rajaratnam (Nov. 8, 2011), *available at* http://www.sec.gov/news/press/2011/2011-233.htm.

8 *See Gupta*, 2013 WL 3784138.

9 *See* Complaint at 2, SEC v. Gupta, No. 11 Civ. 7566 (JSR) (S.D.N.Y. Oct. 26, 2011) [hereinafter Gupta Complaint], *available at* http://www.sec.gov/litigation/complaints/2011/comp22140.pdf; *see also* Peter Lattman, *Ex-Goldman Director to Serve 2 Years in Insider Case*, N.Y. TIMES, Oct. 25, 2012, at B1.

10 *See* Gupta Complaint, *supra* note 9, at 9.

11 *See* Press Release, SEC, SEC Files Insider Trading Charges against Rajat Gupta (Oct. 26, 2011) [hereinafter SEC Press Release No. 2011-223], *available at* http://www.sec.gov/news/press/2011/2011-223.htm.

12 *Id.*

13 *See* Gupta Complaint, *supra* note 9, at 2. On another occasion, Gupta tipped Rajaratnam about Goldman's impending negative financial results for the fourth quarter of 2008. While analysts expected Goldman to earn $2.50 per share, Gupta learned that the company was actually going to lose $2 per share. Gupta immediately shared this information with Rajaratnam, who arranged for certain Galleon funds to completely sell off their Goldman holdings, avoiding losses of more than $3.6 million. *See* SEC Press Release No. 2011-223, *supra* note 11.

sell Goldman shares.[14] During the period of disclosure, Gupta had a variety of business dealings with Rajaratnam and stood to benefit personally from their relationship. Accordingly, it was determined that Gupta wrongfully used his position of power and influence for personal advancement, corroding investor trust and confidence in Wall Street.[15] Although Gupta made selective disclosures to Rajaratnam, Reg FD was unnecessary to reach Gupta's behavior. The insider trading rules were adequate to protect the public from the risks inherent in selective disclosures by creating liability even when the insider did not personally trade.

Next consider a slight variation of the facts. Assume that Gupta disclosed the same type of material nonpublic information to Rajaratnam, such as Goldman's financial results and lucrative investments. Now assume, however, that Rajaratnam waited until Goldman publicly released the information before his funds traded on the basis of that information. Under this scenario, Gupta would not have violated the insider trading laws, and his disclosure would not have generated any market advantage for anyone. Nevertheless, our hypothetical Gupta would still have violated Reg FD, which does not require any unlawful trading. Reg FD goes further than insider trading laws and holds the insider liable even without any evidence of trading and, therefore, no proof of harm to the public.

What justification is there for Reg FD's broad prohibition? In large measure, Reg FD was the SEC's response to the Supreme Court's arguably narrow construction of Rule 10b-5 in *Dirks v. United States*.[16] Rule 10b-5 generally prohibits the purchase or sale of a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security.[17] The *Dirks* court construed Rule 10b-5 to preclude liability for analysts unless an insider provided the information in breach of the insider's fiduciary duty to the corporation's shareholders.[18] The Court rejected the SEC's view that anyone who received nonpublic information from an insider inherited the insider's legal obligation to either publicly disclose the information or abstain from trading.[19] Instead, the Court reasoned that liability would depend on the insider's motive—whether the insider "receives a direct or indirect personal benefit from the disclosure."[20]

14 Judge Rakoff of the Southern District of New York sentenced Gupta to two years in prison and ordered him to pay a $5 million fine. Lattman, *supra* note 9.

15 SEC Press Release No. 2011-223, *supra* note 11.

16 *See* Dirks v. SEC, 463 U.S. 646, 667 (1983).

17 17 C.F.R. § 240.10b5 (2013).

18 *See Dirks*, 463 U.S. at 667.

19 *Id.* at 662–64.

20 *Id.* at 663 (citations omitted).

After the adoption of this personal benefit standard, the SEC determined that it was too difficult to deal with the issue of selective disclosure through direct insider trading means and, on August 15, 2000, it adopted Reg FD.[21] Case law that has developed since the adoption of Reg FD establishes that the SEC's concern was unfounded.[22] As this Article will demonstrate, the SEC has aggressively pursued insider trading cases and attempted to expand its regulatory power to reach all trades made on informational advantages. Although the federal courts have not gone as far as the SEC would like, they have gradually eroded the fiduciary duty requirement established in *Dirks*. The SEC has, therefore, been able to use traditional insider trading laws to pursue cases of selective disclosure resulting in unlawful trading. The *Gupta* case provides just one example of the government's campaign to ferret out selective disclosure and insider trading which has reached inside some of the largest hedge funds and most respected boardrooms.[23] As the SEC declared: "Directors who exploit board room confidences for private gain can be certain they will ultimately be held responsible for their illegal actions."[24] This private gain need not be an economic benefit; it can be in the form of a personal reputational benefit or a gratuity offered to a relative or friend.[25]

Further, over the last decade the government has been using novel techniques to investigate insider trading, including the use of court-

[21] Final Rule: Selective Disclosure and Insider Trading, Exchange Act Release No. 7881, Investment Company Act Release No. 24599, 2000 WL 1201556 (Aug. 15, 2000) [hereinafter SEC Release No. 7881]. Reg FD is codified at 17 C.F.R. §§ 243.100–243.103. The SEC has published a set of interpretations of Reg FD on its website. *See Regulation FD*, U.S. SEC. & EXCHANGE COMMISSION (last updated June 4, 2010), http://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm.

[22] See *infra* Part II.A.3 for a discussion of the gradual demise of the fiduciary duty requirement.

[23] Lattman, *supra* note 9. Over a three-year stretch, more than seventy traders, bankers, and corporate executives have been convicted of insider trading crimes. *See id.*

[24] SEC Press Release No. 2011-223, *supra* note 11 (internal quotation marks omitted). As Fortune magazine reported,

> We've certainly witnessed a bonanza of insider investigations and trials involving corporate secrets in 2012: Raj Rajaratnam of Galleon Group, SAC Capital, and Tiger Asia Management as a few examples. In all these cases, inside information was the seedling for the alleged insider trading. Executives are often put in positions where they can take advantage of inside information.

Eleanor Bloxham, *Why Netflix Got into Hot Water*, FORTUNE (Dec. 17, 2012, 3:51 PM), http://management.fortune.cnn.com/tag/regulation-fd.

[25] Bloxham, *supra* note 24.

> Corporate execs are under investigation for insider trading at Big Lots . . . , VeriFone Systems . . . , Body Central . . . , Micrel . . . , and Cobalt International Energy . . . , the *Wall Street Journal* reported. Based on their analysis, at least 4,185 executives made trades since 2004 that could be suspicious.

Id.

authorized secret wiretaps, whistleblowers, surveillance programs, and tracking of trades.[26] The expanded use of wiretaps—traditionally only used in drug prosecutions and organized crimes—to investigate insider trading was controversial. The Second Circuit, however, has recently validated its use in the case against Raj Rajaratnam.[27] The use of these techniques will ease the government's burden of investigating and prosecuting insider trading, rendering Reg FD superfluous.

Reg FD is not only unnecessary, as this Article will demonstrate, but it also raises normative concerns. While Reg FD has been successful in achieving the immediate goal of reducing selective disclosures and increasing the quantity of public disclosures, it has unintended negative consequences on analysts and retail investors. At least some empirical studies have concluded that Reg FD impairs the efficient functioning of capital markets by depriving investors of a valuable filter that ultimately provides them more accurate, reliable, and informative reports than an issuer would ever provide.[28] The concern is not that the issuer discloses information for analyst review, but rather that the analysts use it to profit at the expense of the general public. Rather than focusing on the selective disclosure by issuers and providing equal access to all investors, the SEC should focus on the real problem of trading.

Beyond these normative concerns, Reg FD also poses serious First Amendment challenges. At its essence Reg FD requires corporate executives to restrict their speech entirely or to engage in unwanted disclosure with the public at large. The former chills protected speech and the latter mandates it. In the only case to challenge the constitutionality of Reg FD, the court exercised constitutional avoidance and ruled in favor of the issuer on other grounds.[29] It is increasingly likely after the Court's robust articulation of corporate political speech rights in *Citizens United v. FEC* that a First Amendment challenge to Reg FD will be brought.[30] In *Citizens United*, the Court held that corporations engaging in political speech are entitled to the same First Amendment protection as individuals.[31] If challenged, the broad prophylactic restrictions on truthful non-misleading speech for the purpose of protecting investors would not likely withstand First Amendment scrutiny. Further, if Reg FD is ultimately subject to strict scrutiny under the political speech doctrine, the regulation would have virtually no chance of surviving.

26 See *infra* Part II.C for a description of these techniques.
27 *See* United States v. Rajaratnam, 719 F.3d 139 (2d Cir. 2013).
28 See *infra* Part III.B for a discussion of these empirical studies.
29 *See* SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694 (S.D.N.Y. 2005).
30 *See* Citizens United v. FEC, 558 U.S. 310, 364 (2010).
31 *Id.* at 310.

While scholars, commentators, and practitioners have debated the anticipated and actual effects of Reg FD for over a decade, none have examined the need for regulation in light of the expansive interpretation of the insider trading regulations and the government's use of novel investigatory techniques. Further, few commentators have considered the constitutionality of the regulation, and none have considered it since the Supreme Court's expansive interpretation of corporate political speech rights in *Citizens United v. FEC*.

This Article will demonstrate that Reg FD is not only unnecessary in light of the gradual erosion of the fiduciary duty requirement and the novel investigatory techniques available to the government, but also that it is unlikely to withstand a First Amendment challenge. Part I discusses the purpose of Reg FD and the conduct prohibited by the regulation. Part II examines insider trading cases to show the gradual erosion of the fiduciary duty requirement under Rule 10b-5, the recent pursuit of expert networks and hedge funds, and the novel investigatory techniques used by the government. Part III then demonstrates that the conduct prohibited under Reg FD can largely be pursued under traditional insider trading rules and discusses some of the unintended negative consequences of the regulation. Part IV establishes that, if challenged, Reg FD would likely be struck down as an unconstitutional restriction on corporate speech, under either the commercial speech doctrine or the more restrictive political speech standard set forth in *Citizens United*.[32] The last part then suggests that the Supreme Court might bring this issue to a head by invalidating Reg FD as an unlawful restriction on speech or the SEC may repeal the regulation. If there are concerns that current insider trading laws are inadequate, Congress or the SEC could enact fraud-based legislation or regulation that focuses on trading, rather than on information flow.

I. THE PURPOSE AND SCOPE OF REGULATION FAIR DISCLOSURE

When corporate insiders selectively disclose information to analysts or institutional investors before releasing it to the general public, those with access to the information can incorporate it into their trading strategies before the general public can react.[33] In other words,

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32 The source of power for the regulation has been debated at length and will not be discussed in this Article. *See* Brief of the Chamber of Commerce of the United States as Amicus Curiae in Support of Motion to Dismiss, *Siebel Sys.*, 384 F. Supp. 2d 694 (No. 04 CV 5130 (GBD)), 2005 WL 176296 [hereinafter Chamber Amicus Brief] (the brief claims invalidation of Reg FD arguing that the regulation exceeds the SEC's statutory authority, and endows in an administrative agency the substantive policy choices traditionally reserved for Congress).

33 *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (codified at 17 C.F.R. pts. 240, 243, 249).

selective disclosure produces an inequality between analysts or institutional investors and individual investors.[34] According to the SEC, this trading advantage undermines the public's confidence in the fairness of capital markets.[35] Investors who see a stock's price change dramatically and only later become privy to the information responsible for that change will resent that they are not on a level playing field with market insiders and may exit the capital markets.[36]

In its Proposing Release, the SEC provided several other justifications for Reg FD.[37] First, the SEC wanted to encourage corporate insiders to disseminate material information to the public promptly to avoid the risk that insiders would selectively disclose material information to particular analysts or institutional investors to curry favor with them.[38] Second, a full disclosure requirement would encourage analysts to engage in more independent research and evaluation of issuers as they would no longer be able to rely on corporate insiders to guide their earnings forecasts.[39] Commentators have expressed concern that selective disclosure results in less independent research and more favorable reports because analysts fear being cut off from access to the flow of nonpublic information.[40] Companies may restrict an analyst's access to corporate information if the analyst publishes a negative or unfavorable research report on their stock.[41] Finally, technology has made the rapid dissemination of information to the general public more practical.[42] The Internet has made it possible for companies to address the general public and has eliminated the need for analysts to act as "information intermediaries."[43]

To preserve confidence in securities markets and prevent the use of inside information for trading purposes, in October of 2000, the SEC promulgated Reg FD, which essentially prohibits public companies from making selective disclosures.[44] This proposed regulation "represent[ed] a significant departure from the U.S. disclosure regime as it has existed for over 65 years."[45] Reg FD provides for simultaneous or prompt public disclosure as follows:

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34 *Id.*

35 *See* SEC Initial Reg FD Proposal, *supra* note 2.

36 *Id.*

37 *Id.*

38 *Id.*

39 *Id.* at 72,592.

40 *Id.*

41 Amitabh Dugar & Siva Nathan, *Analysts' Research Reports: Caveat Emptor*, 5 J. INVESTING 1, 13 (1996) (providing examples of corporate responses to unfavorable reports).

42 *See* SEC Initial Reg FD Proposal, *supra* note 2 (one justification for Reg FD is that information can be simultaneously disbursed to market insiders and individual investors).

43 *Id.* (listing technologies that make it possible to address the general public).

44 17 C.F.R. § 243.100 (2000).

45 Letter from Lee Spencer, Jr. & George Schieren to Jonathan Katz, *supra* note 5.

> Whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any [securities market professionals or holders of the issuer's securities who may well trade on the basis of the information], the issuer shall make public disclosure of that . . . [s]imultaneously, in the case of an intentional disclosure; and . . . [p]romptly, in the case of a non-intentional disclosure.[46]

Reg FD is not a mandatory disclosure rule in that it does not require issuers to share any information with the general public if it chooses to keep the information confidential. If the issuer discloses material information to analysts or institutional investors, however, Reg FD requires the issuer to also make public disclosure of that information.[47] The required public disclosure may be made by filing a Form 8-K, or by another method that is "reasonably designed to effect broad, non-exclusionary distribution of the information to the public."[48] The SEC recently determined that companies can use social media outlets, such as Facebook and Twitter, to announce material information in compliance with Reg FD provided that investors "have been alerted about which social media will be used to disseminate such information."[49] As the SEC explained, "[m]ost social media are perfectly suitable methods for communicating with investors, but not if the access is restricted or if investors don't know that's where they need to turn to get the latest news."[50]

In response to public comments, the SEC limited the scope of Reg FD making the final version of the regulation arguably under-inclusive. The SEC limited the types of issuer personnel covered by the regulation to "senior officials and those persons who regularly communicate with securities market professionals or with security holders."[51] Further, the regulation only applies to communications "made to securities market professionals and to holders of the issuer's securities under circumstances in which it is reasonably foreseeable that the security holder will trade on the basis of the information."[52] The purpose of these limitations was to exempt from Reg FD "a variety of legitimate,

46 17 C.F.R. § 243.100.

47 SEC Release No.7881, *supra* note 21.

48 *Id.* at *1.

49 Press Release, SEC, SEC Says Social Media OK for Company Announcements if Investors are Alerted (Apr. 2, 2013) [hereinafter SEC Press Release No. 2013-51], *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171513574; *see also* SEC Release No. 7881, *supra* note 21.

50 SEC Press Release No. 2013-51, *supra* note 49 (internal quotation marks omitted).

51 SEC Release No. 7881, *supra* note 21, at *5. Under the rule, senior officials include directors, executive officers, investor relations or public relations officers, and individuals acting under their direction. *Id.* at *44. The rule also covers officers, employees, or agents of the company who regularly communicate with securities market professionals or security holders. *Id.*

52 *Id.* at *38.

ordinary-course business communications or to disclosures to the media."[53]

Although arguably under-inclusive with respect to the persons whose communications are covered, and the recipients that are covered, Reg FD is over-inclusive in that it restricts, burdens, and compels speech that is irrelevant to the SEC's stated purposes. The regulation targets all material nonpublic information, even if such speech does not result in any trading activity. Without subsequent trading, however, there is no harm to investors. Although subsequent trading is evidence of materiality, the SEC does not need to prove that any trading occurred in order to establish a violation of Reg FD.[54]

Further, Reg FD captures speech, even if it was not "used" in making a trading decision. Recipients of information who would have traded despite the possession of the information do not pose harm to investors. Just as the SEC does not have to prove that any trading took place after the disclosure, it does not have to prove that a trader "used" the information—mere possession of the information is enough to establish a violation.[55] This is different than liability for insider trading under Section 10(b) and Rule 10b-5, which prohibit the actual trading of securities based on material nonpublic information.[56] The SEC created an affirmative defense to any charge of insider trading where the shareholder can demonstrate that the material nonpublic information was not a factor in the trading decision.[57] This defense includes situations where the trade was made pursuant to a contract, instructions given to another, or a written plan created before the shareholder received the information.[58]

Unlike insider trading, Reg FD does not create a private right of action for private shareholders. Rather, the SEC enforces the regulation and can seek remedies including injunctive relief, cease-and-desist orders, monetary penalties, and required disclosure of the violation.[59] Although enforcement actions under Reg FD have been rare,[60] the SEC's recent enforcement actions demonstrate that the SEC has not given up its pursuit and prosecution of Reg FD violations.[61] These enforcement

53 *Id.* at *5.

54 *See generally* Antony Page, *Taking Stock of the First Amendment's Application to Securities Regulation*, 58 S.C. L. REV. 789 (2007).

55 *Id.* at 803–04.

56 *See infra* notes 65–66.

57 17 C.F.R. § 240.10b5–1 (2013).

58 *Id.*

59 SEC Initial Reg FD Proposal, *supra* note 2, at 72,598.

60 As of April 2011 only about a dozen cases had been brought alleging violations of Reg FD. *See* Steven Davidoff Solomon, *In Netflix Case, A Chance to Re-Examine Old Rules*, N.Y. TIMES DEALBOOK (Dec 12, 2012, 7:13 PM), http://dealbook.nytimes.com/2012/12/11/in-netflix-case-a-chance-for-the-s-e-c-to-re-examine-old-regulation.

61 *See, e.g.*, SEC Press Release No. 2013-51, *supra* note 49.

actions include cases against the former head of investor relations at First Solar, Inc.,[62] Office Depot and its former CEO and CFO,[63] Presstek, Inc. and its former CEO,[64] and the former CFO of American Commercial Lines.[65]

One of the SEC's most recent investigations of potential Reg FD violations involves Netflix CEO Reed Hastings. Hastings posted on his personal Facebook page a statement that Netflix's "monthly online viewing had exceeded one billion hours for the first time."[66] This posting was the first time Hastings had used his Facebook page to convey information about Netflix, and Netflix had not previously informed investors that the page might be used for such purposes.[67] Further, investors did not receive this information through any traditional means such as a press release.[68]

Following the investigation, the SEC did not allege wrongdoing by Hastings or Netflix because of the uncertainty surrounding Reg FD's application to social media. Instead, the SEC issued a report explaining that Reg FD applies to corporate disclosures made through social media channels just as it applies to communications through more traditional means.[69] Investors should therefore receive advance notice if a company intends to use social media as a means of disseminating information.[70] Accordingly, if Hastings posted a similar message today without advance notice to investors, he would likely be found to have violated Reg FD.

At first glance, the Netflix case may appear very different from the Gupta case discussed in the introduction, but selective disclosure and insider trading violations are quite similar.[71] CEO Reed Hastings' Facebook message was perhaps not for his immediate personal gain, but he may have unwittingly turned his Facebook readers into insiders.[72]

62 Polizzotto, Exchange Act Release No. 70337, 2013 WL 4773958 (Sept. 6, 2013).

63 *See* Office Depot, Inc., Exchange Act Release No. 63152, 2010 WL 4135029 (Oct. 21, 2010); Odland, Exchange Act Release No. 63153, 2010 WL 4134968 (Oct. 21, 2010); McKay, Exchange Act Release No. 63154, 2010 WL 4134969 (Oct. 21, 2010).

64 *See* Presstek, Inc., Litigation Release No. 21443, 2010 WL 784231 (Mar. 9, 2010).

65 *See* Black, Litigation Release No. 21222, 2009 WL 3047574 (Sept. 24, 2009).

66 SEC Press Release No. 2013-51, *supra* note 49.

67 *Id.*

68 *Id.*

69 *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings, Exchange Act Release No. 69279, 2013 WL 5138514 (Apr. 2, 2013).

70 *Id.* at *6–7.

71 Bloxham, *supra* note 24.

72 *Id.*

II. Recent Expansion of Insider Trading Cases

Insider trading is generally prohibited by Section 10(b)[73] and Rule 10b-5 of the Exchange Act.[74] The Exchange Act was enacted after the 1929 stock market crash to restore confidence in the nation's securities market by governing securities transactions on secondary markets. Rule 10b-5 prohibits any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security.[75] The broad language of the rule did not specify the limits of insider trading liability and has forced courts to define those limits on a case-by-case basis.[76] One such limitation is that liability must be premised on a breach of "fiduciary or other similar relation of trust and confidence."[77] Recently, the SEC and the Department of Justice (DOJ) have been pushing the boundaries of firmly established insider trading definitions by expanding the confines of fiduciary relations, pursuing expert networks and hedge funds, and using secret wiretaps as an investigative tool.[78]

A. *Expanding Confines of Fiduciary Relations*

Insider trading laws were originally designed to protect market fairness and integrity by preventing insiders, who owe fiduciary duties to their corporations, from illegally trading and profiting from material nonpublic information. The Supreme Court expanded the fiduciary principles in 1984, when it recognized that a tippee, under certain circumstances, may inherit the fiduciary obligations of a tipper. The

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73 Section 10(b) of the Exchange Act provides:

> It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (2006).

74 Rule 10b-5 provides:

> It shall be unlawful for any person . . . [t]o employ any device, scheme, or artifice to defraud, [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2010).

75 *Id.*

76 Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 889–90 (2010).

77 Chiarella v. United States, 445 U.S. 222, 228 (1980).

78 Patrick Craine & Lashon Kell, *Prosecuting Insider Trading: Recent Developments and Novel Approaches*, 59 ADVOC. (TEXAS) 45, 48 (2012).

Court again expanded the boundaries of the fiduciary requirement in 1997 when it held that liability may be premised on a breach of the fiduciary duty owed by a corporate outsider to the corporation. Although a breach of fiduciary duty remains a required element of an insider trading violation, the SEC and the courts have broadened the definition of fiduciary duty so that the element is easily satisfied.[79] In fact, several scholars have concluded that insider trading liability under Rule 10b-5 is not limited to breaches of a fiduciary duty because there has been a gradual erosion of the requirement.[80]

1. Classical Theory of Insider Trading: Limiting Liability to Corporate Insiders Owing a Fiduciary Duty to Company Shareholders

Under the traditional theory of insider trading, referred to as the "classical theory," liability is premised on the breach of a fiduciary duty that a corporate insider[81] or temporary insider[82] owes to his company and its shareholders. In *SEC v. Texas Gulf Sulphur Co.*, the Supreme Court held that Section 10(b) and Rule 10b-5 require corporate insiders possessing material information to either disclose the information or refrain from trading.[83] This disclosure duty arises because there is "a fiduciary or other similar relation of trust and confidence" between the corporate insider and the shareholders.[84] The insider breaches this duty by trading on the basis of nonpublic information obtained through his position within the company without disclosing the information.[85]

A few years later, in *Chiarella v. United States*, the government attempted to expand the scope of insider trading liability by prosecuting

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79 Hazen, *supra* note 76, at 881 (concluding that trading prohibitions properly extend liability to certain individuals who are not under a fiduciary duty to keep the information confidential).

80 *See, e.g.*, *id.* at 903; Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1379 (2009) ("[W]hile this view can be justified by the policy objectives underlying the Supreme Court's decisions, it currently lacks a solid doctrinal foundation."). Nagy proposes that either Congress adopt a statute that defines and directly prohibits insider trading, or the courts supplement or replace the classical and misappropriation theories with other fraud-based theories of liability. *Id.* at 1365.

81 Corporate insiders include corporate directors, officers, and employees. *See* United States v. O'Hagan, 521 U.S. 642, 652 (1997).

82 Temporary insiders include certain categories of professionals such as attorneys, accountants, consultants, investment bankers, and others who receive confidential information from a company during the course of professional service. *See* Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983). The Court reasoned that a temporary insider acquires a fiduciary duty with the company, and should be liable for insider trading if he uses that confidential information to trade. *See id.*

83 SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (explaining that officers and employees cannot purchase shares of the company after receiving favorable information about its mining activities).

84 Chiarella v. United States, 445 U.S. 222, 228 (1980).

85 *Tex. Gulf Sulphur Co.*, 401 F.2d at 848.

a corporate outsider, a financial printer, who did not owe any fiduciary duty to the corporation's shareholders.[86] After learning that a corporation was planning to acquire other corporations, the printer purchased the stock of the target corporations.[87] The district court found the printer guilty, the Second Circuit affirmed, but the Supreme Court reversed the conviction.[88] The Court reasoned that the duty to disclose or abstain only exists when there is a pre-existing fiduciary relationship between the person trading and the corporation in whose shares he traded.[89] Without this fiduciary relationship there is no duty to speak and, therefore, no fraud or deception.[90] The Court cautioned that to hold otherwise and recognize a general disclosure duty, would require "all participants in market transactions to forgo actions based on material, nonpublic information."[91]

While reiterating that market participants owe no general duty to other market participants,[92] the Supreme Court in *Dirks v. SEC* recognized that insider trading liability can extend to analysts or other tippees who receive nonpublic information from insiders under certain circumstances.[93] Dirks, a securities trader and analyst, received material, nonpublic information from a former corporate officer that the company had grossly overstated its assets by engaging in fraudulent practices.[94] Dirks investigated the allegations and then disclosed the information to his clients and investors who traded based on the information.[95]

The SEC investigated Dirks' role in uncovering the fraud and charged him with insider trading violations under Rule 10b-5.[96]

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86 *Chiarella*, 445 U.S. 222.

87 *Id.* at 224.

88 *Id.* at 225.

89 *Id.* at 232–33.

90 *Id.* The fiduciary duty arises from "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." *Id.* at 227.

91 *Id.* at 233.

92 As the *Dirks* court stated:

> We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information "was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence." Not to require such a fiduciary relationship, we recognized, would "depar[t] radically from the established doctrine that duty arises from a specific relationship between two parties" . . . .

Dirks v. SEC, 463 U.S. 646, 654–55 (1983) (alterations and first omission in original) (citation omitted).

93 *Id.* at 655–62.

94 *Id.* at 648–49.

95 *Id.* at 649.

96 *Id.* at 650.

Adhering to the reasoning in *Chiarella*, the Court explained that the duty to disclose material nonpublic information prior to trading arises from the fiduciary relationship between the parties, rather than from mere possession of information.[97] The Court rejected the SEC's view that anyone who received nonpublic information from an insider inherited the insider's legal obligation to either publicly disclose the information or abstain from trading.[98] The tippee would only inherit the insider's fiduciary duty to the shareholders "when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."[99]

Further, the Court reasoned that liability would depend on the insider's motive—"whether the insider personally will benefit, directly or indirectly, from [the] disclosure."[100] The Court broadly defined personal benefit to include not only "pecuniary gain," such as a cut of the take or a gratuity from the tippee, but also a "reputational benefit" or the benefit one would obtain from simply "mak[ing] a gift of confidential information to a trading relative or friend."[101] Because the insider in *Dirks* was motivated by a desire to expose fraud, rather than any monetary or personal benefit, the insider did not breach his fiduciary duties to the shareholders and there could not have been a derivative breach by Dirks.[102] Accordingly, Dirks did not have a duty to abstain from the use of the inside information he obtained and was not liable for insider trading.[103]

2. Misappropriation Theory of Insider Trading: Expanding Liability to Outsiders Owing a Fiduciary Duty to the Source of Information

Limiting insider trading liability to corporate insiders and those who received tips from insiders proved insufficient to protect the integrity of the securities markets.[104] Accordingly, in *United States v.*

97 *Id.* at 657–58.

98 *Id.*

99 *Id.* at 660.

100 *Id.* at 662.

101 *Id.* at 663–64.

102 *Id.* at 666.

103 *Id.* at 667.

104 In *Chiarella v. United States*, the government attempted to expand the scope of insider trading liability by prosecuting a corporate outsider, a financial printer, who did not owe any fiduciary duty to the corporation's shareholders. 445 U.S. 222 (1980). The printer was able to discern that a corporation was planning to acquire other corporations and then purchased the stock of the target corporations. *Id.* at 224. The district court found the printer guilty, the Second Circuit affirmed, but the Supreme Court reversed the conviction. *Id.* at 225. The Court reasoned that the duty to disclose or abstain only exists when there is a pre-existing fiduciary relationship between the defendant and the corporation in whose shares he traded. *Id.* at 232–33. As the Court

O'Hagan, the Supreme Court adopted another theory of insider trading liability, known as the "misappropriation theory."[105] This theory premises liability on a breach of a duty owed by a corporate outsider to the source of the information.[106] As the Court explained, whereas the classical theory "premis[es] liability on a fiduciary relationship between [the] company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[107] O'Hagan was a partner of a law firm that was advising a corporation on a potential tender offer for another corporation.[108] The government brought an action for insider trading after O'Hagan purchased call options for the acquired company.[109] As in *Chiarella*, O'Hagan contended that he and his firm owed no fiduciary duty to the acquired company and therefore could not be liable for insider trading.[110] The Court disagreed, holding O'Hagan liable for insider trading because he misappropriated material, nonpublic information in breach of a duty he owed to his client.[111]

The O'Hagan decision was significant because it expanded insider trading liability to corporate outsiders who owe no fiduciary duty to the corporation or its shareholders.[112] The Court was clear, however, in limiting the misappropriation theory to "those who breach[ed] a recognized duty" owed to the information source.[113] For years, lower courts determined on an ad hoc basis what circumstances might provide the duty of trust or confidence required under the misappropriation theory.[114] In order to mitigate the need to examine the details of particular relationships, the SEC adopted Rule 10b5-2 which listed certain situations that would presumptively give rise to a duty of trust or confidence. These situations include:

(1) Whenever a person agrees to maintain information in confidence;
(2) Whenever the person communicating the material nonpublic

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explained, it could not affirm the conviction "without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information." *Id.* at 233.

105 United States v. O'Hagan, 521 U.S. 642, 654 (1997).

106 *Id.* at 652.

107 *Id.*

108 *Id.* at 647.

109 *Id.* at 647–49.

110 *See* Brief for Respondent James Herman O'Hagan, *O'Hagan*, 521 U.S. 642 (No. 96–842), 1997 WL 143801, at *13.

111 *O'Hagan*, 521 U.S. at 677–78.

112 Elizabeth A. Odian, Note, SEC v. Dorozhko*'s Affirmative Misrepresentation Theory of Insider Trading: An Improper Means to a Proper End*, 94 MARQ. L. REV. 1313, 1326 (2011).

113 *O'Hagan*, 521 U.S. at 666.

114 *See, e.g.*, United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992); United States v. Reed, 601 F. Supp. 685 (S.D.N.Y. 1985), *rev'd*, 773 F.2d 447 (2d Cir. 1985).

> information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling . . . .[115]

The history of the misappropriation theory and Rule 10b-5 illustrates the SEC's and judiciary's tendency to expand the reach of insider trading liability.

3. Gradual Demise of the Fiduciary Duty Requirement

The different theories of insider trading liability share one common element: liability premised upon the breach of a fiduciary duty or similar relationship of trust or confidence.[116] Only those individuals, such as insiders, temporary insiders, misappropriators, or tippees, who breach a duty to the company, the shareholders, or the source of information, could be liable for insider trading.[117] Outsiders with no fiduciary duty have generally avoided liability under Supreme Court precedent.[118] However, the SEC has attempted to expand its regulatory power to reach all trades made on informational advantages.[119]

Despite repeated rejections by the Supreme Court in *Chiarella*, *Dirks*, and *O'Hagan*,[120] the SEC has continued to strive for something close to a parity of information approach to insider trading.[121] This approach would prohibit all trades made on nonpublic information irrespective of how such information was received. Rather than completely eliminating the fiduciary duty requirement, the government

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115 17 C.F.R. § 240.10b5-2(b) (2013); *see* SEC Release No. 7881, *supra* note 21.

116 Mark F. DiGiovanni, Note, *Weeding Out a New Theory of Insider Trading Liability and Cultivating an Heirloom Variety: A Proposed Response to* SEC v. Dorozhko, 19 GEO. MASON L. REV. 593, 603 (2012) (proposing a new theory of insider trading liability based on constructive breaches, whereby a constructive trust would be created when one wrongfully obtains property from another).

117 *O'Hagan*, 521 U.S. at 652.

118 *See* Odian, *supra* note 112, at 1320.

119 *Illegal Insider Trading: How Widespread Is the Problem and Is There Adequate Criminal Enforcement?: Hearing Before the S. Comm. on the Judiciary*, 109th Cong. 138–39 (2006) (statement of Linda C. Thomsen, Director of Enforcement, SEC).

120 See *supra* Part II.A for a discussion of the Supreme Court's fiduciary duty requirement in insider trading cases.

121 *See* Ryan M. Davis, Note, *Trimming the "Judicial Oak": Rule 10b5-2(b)(1), Confidentiality Agreements, and the Proper Scope of Insider Trading Liability*, 63 VAND. L. REV. 1469, 1470 ("Rule 10b-5 . . . has experienced expansive growth since its creation, developing from a mere statutory catchall provision in the securities laws to one of the SEC's chief weapons in combating insider trading and other fraudulent actions in the securities markets.").

and the courts seem to be manufacturing a fiduciary duty merely to satisfy the requirement, which is tantamount to eliminating the fiduciary duty requirement all together.[122] Although the Supreme Court has not endorsed a doctrine expansive enough to reflect this view, several lower courts and the SEC have in effect concluded that the offense of insider trading does not require the breach of a fiduciary duty.[123]

The SEC has recently challenged the traditional scope of fiduciary relationships when it pursued insider trading charges against Mark Cuban, the billionaire owner of the National Basketball Association's Dallas Mavericks.[124] The case illustrates the SEC's willingness to push the boundaries of the fiduciary relationship and pursue insider trading violations more aggressively.[125] Cuban was a large minority shareholder of Mamma.com stock.[126] The CEO of the company contacted Cuban and told him that he had confidential information he wished to convey.[127] Cuban agreed to keep the information confidential and allegedly agreed not to trade on the basis of the information. After receiving these assurances, the CEO informed Cuban that the company was planning a private investment in public equity (PIPE) transaction and that he hoped Cuban would purchase in the offering.[128] Cuban responded that he would not participate as he believed PIPE offerings dilute existing shareholders, and commented, "[w]ell now I'm screwed. I can't sell."[129] However, after discussing the matter with the company's investment bankers, Cuban decided to sell all of his shares in the

122 *See, e.g.*, Nagy, *supra* note 80, at 1319 ("Despite the Supreme Court's explicit dictate that fiduciary principles underlie the offense of insider trading, there have been recent repeated instances in which lower federal courts and the [SEC] have disregarded these principles."); *see also* Hazen, *supra* note 76, at 903 ("Rule 10b-5 liability is not limited to breaches of a fiduciary duty.").

123 *See* SEC v. Dorozhko, 574 F.3d 42, 44 (2d Cir. 2009); *see also* Joanna B. Apolinsky, *Insider Trading as Misfeasance: The Yielding of the Fiduciary Requirement*, 59 U. KAN. L. REV. 493, 539 (2011) ("[S]ection 10(b) and Rule 10b-5 do not require a fiduciary duty or similar relationship of trust and confidence to satisfy the necessary deception. Deception may exist by any appropriate means."); Nagy, *supra* note 80, at 1319.

124 SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated*, 620 F.3d 551 (5th Cir. 2010). In an earlier case, *SEC v. Kornman*, the court found an outsider liable for insider trading when he traded on information acquired during meetings to discuss a potential acquisition, even though the parties never entered into a confidentiality agreement. 391 F. Supp. 2d 477, 480–82 (N.D. Tex. 2005). The court reasoned that "superior knowledge . . . served[d] as an indicator that a duty of trust and confidence had developed between [the parties]." *Id.* at 489. The court relied on the characteristics of "superiority or dominance" in determining that a duty in fact existed. Apolinsky, *supra* note 123, at 512 (proposing that insider trading be characterized as the commission of a wrong or misfeasance, rather than failure to disclose or nonfeasance, so that courts will not need to determine whether a special relationship exists sufficient to impose a duty to disclose).

125 Craine & Kell, *supra* note 78, at 48.

126 *Cuban*, 620 F.3d at 552.

127 *Id.* at 555.

128 *Id.*

129 *Id.*

company. When the PIPE offering was publicly disclosed, the company's stock immediately declined, and Cuban avoided a loss of $750,000.

The SEC filed an enforcement action against Cuban for violating the insider trading laws and the district court dismissed the action. On appeal, the Fifth Circuit explained that there was a "paucity of jurisprudence" on the issue of whether a duty of trust and confidence exists where confidential information is disclosed to a person who was not seeking the information and did not otherwise owe a duty to the corporation or its shareholders.[130] Ultimately the court vacated and remanded, holding that insider trading liability may be predicated on an unwanted duty where the recipient of the information was not seeking the information, but agreed not to trade on the basis of the information.[131] Many commentators have critiqued this decision as expanding the scope of Section 10(b) and Rule 10b-5 beyond the policies of the insider trading laws.[132]

Additional recent examples of the SEC pursuing insider trading charges in the absence of a fiduciary duty are cases involving affirmative misrepresentations as illustrated by the computer hacking cases.[133] The *SEC v. Dorozhko* case involved a computer hacker who downloaded a company's earnings report a few hours before it was scheduled to be released.[134] Based on the report, Dorozhko purchased put options in the company's stock and then sold them for a significant profit after the report was released.[135] The Second Circuit held that a breach of fiduciary duty is not a required element for an insider trading violation involving a misrepresentation.[136] The affirmative misrepresentation, unlike a mere nondisclosure, is deceptive in and of itself and does not require an

130 *Id.* at 557–58.

131 *Id.* at 551, 558. The Fifth Circuit did not define what kind of relationship is necessary to support an insider trading violation. Specifically, whether the duty of trust and confidence required by the Supreme Court precedents is limited to fiduciary-like relationships and express agreements not to trade or, does it apply wherever there is a confidentiality agreement? *Id.*

132 Starkey De Soto, *"Well, Now I'm Screwed": The Ever-Expanding Liability for Outsider Trading*, 33 WHITTIER L. REV. 275, 301 (2012) (proposing that liability for insider trading should only be found in cases where a defendant has engaged in deceptive or fraudulent behavior).

133 The computer hacker cases involve similar facts. In each, the SEC alleged that the defendants had used fake passwords and other means of high-tech trickery to gain access to computer databases that stored confidential market-moving information about securities issuers. In the first two computer hacker cases the district judges granted the relief requested by the SEC, but without issuing a published decision. *See* Haavel, Litigation Release No. 20134, 2007 WL 1574065, at *1 (May 31, 2007); Blue Bottle Ltd., Litigation Release No. 20095, 2007 WL 1238669, at *1 (Apr. 27, 2007).

134 *See* SEC v. Dorozhko, 574 F.3d 42, 44 (2d Cir. 2009).

135 *Id.* This trading activity resulted in Dorozhko realizing a profit of over $286,000 and a 700% return on his investment overnight. *Id.*

136 *Id.* at 50 (eliminating the fiduciary duty requirement in cases involving affirmative misrepresentations rather than nondisclosures).

additional showing of a breach of fiduciary duty to be fraudulent.[137] As the court explained, "[a]bsent a controlling precedent that 'deceptive' has a more limited meaning than its ordinary meaning, we see no reason to complicate the enforcement of Section 10(b) by divining new requirements."[138] However, the court remanded for a determination of whether Dorozhko had affirmatively misrepresented his identity in hacking into the computer server or whether he just exploited a weakness in the server to gain unauthorized access in a nondeceptive manner.[139] Upon remand, the court granted the SEC's unopposed motion for summary judgment.[140]

This holding significantly extended the SEC's policing power by allowing a trader, who is an outsider, to be liable for insider trading if he made an affirmative misrepresentation to obtain the nonpublic information.[141] Legal scholars immediately criticized the decision for conflicting with Supreme Court precedent, which they interpreted as foreclosing insider trading liability where an outsider owes no fiduciary duty to the company, its shareholders, or the source.[142] They argued that because computer hackers owe no fiduciary duty, their conduct, while punishable under wire fraud and computer fraud statutes,[143] is not punishable under insider trading statutes.[144]

The SEC's victories in cases involving outsiders who receive unwanted information and affirmative misrepresentations, have "fueled the demise of fiduciary limitations in the law of insider trading."[145]

B. *Pursuing Expert Networks and Hedge Funds*

Recently, the SEC and DOJ have focused on investigating and prosecuting "expert networks." Expert networks are primary research firms that hire industry experts such as current or former company

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137 *Id.* The Court explained that previous Supreme Court precedent dealt only with nondisclosure, which requires a breach of fiduciary duty to be fraudulent.

138 *Id.* at 49.

139 *Id.* at 51.

140 *See* Dorozhko, Litigation Release No. 21465, 2010 WL 1213430, at *1 (Mar. 29, 2010).

141 *See* Odian, *supra* note 112, at 1317.

142 *See, e.g.*, Stephen M. Bainbridge, *The Second Circuit's Egregious Decision in* SEC v. Dorozhko, PROFESSORBAINBRIDGE.COM (July 29, 2009), http://www.professorbainbridge.com/professorbainbridgecom/2009/07/the-second-circuits-recent-decision-in-sec-v-dorozhko-available-here-dealt-with-one-of-the-questions-left-open-by-the.html; Joel M. Cohen, *Erosion of the Fiduciary Duty Requirement in Insider Trading Actions*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. BLOG (July 29, 2010, 9:22 AM), http://blogs.law.harvard.edu/corpgov/2010/07/29/erosion-of-the-fiduciary-duty-requirement-in-insider-trading-actions..

143 *See, e.g.*, 18 U.S.C. § 1030 (2006).

144 *See* SEC v. Cuban, 620 F.3d 551, 552 (5th Cir. 2010); *see also* Robert Steinbuch, *Mere Thieves*, 67 MD. L. REV. 570, 589 (2008).

145 Nagy, *supra* note 80, at 1344.

employees, to be consultants to institutional investors making investment decisions.[146] These firms typically pay consultants several hundred dollars an hour to discuss information about their company or industry.[147] Internal policies allegedly prevent consultants from disclosing confidential information.[148] According to a recent survey, more than one third of institutional investment-management firms use expert networks.[149] Although institutional investors had been using expert networks legally for years, the government's view is that no employees should be communicating with expert networks.[150]

For the past few years, the SEC has been aggressively pursuing expert networks. In one such case, the SEC charged two employees of an expert network firm, Primary Global Research LLC (PGR), and four consultants with insider trading for illegally tipping hedge funds and other investors.[151] An amended complaint, filed a few days later, also charged a New York based hedge fund, and four hedge fund portfolio managers and analysts with insider trading.[152] The government alleged in the amended complaint that the portfolio managers and analysts illegally traded on confidential information provided by technology company employees moonlighting as expert network consultants.[153] The case settled and the defendants agreed to disgorge profits, pay pre-judgment interest, and not to act as an officer or director of a public company.[154] This was the first case that the SEC brought against traders in its ongoing investigation of expert networks.

In addition to the SEC actions, one of the expert network consultants, Winifred Jiau, was prosecuted by the DOJ in June 2011.[155]

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146 *See* Susan Pulliam, Michael Rothfeld, Jenny Strasburg & Gregory Zuckerman, *U.S. in Vast Insider Trading Probe*, WALL ST. J., Nov. 20, 2010, at A1.

147 *Id.*

148 *Id.*

149 *Id.*

150 Charlie Gasparino & Sital Patel, *Exclusive: Regulators May Expand Definition of Insider Trading*, FOX BUS. (Feb. 15, 2012), http://www.foxbusiness.com/industries/2012/02/15/regulators-may-expand-definition-insider-trading.

151 Complaint, SEC v. Longoria, No. 11-CV-0753 (S.D.N.Y. Feb. 3, 2011), 2011 WL 324641. The previous year, the government pursued insider trading charges against employees of PGR, and other consultants. Sealed Complaint, United States v. Shimoon, No. 10 MAG 2823 (S.D.N.Y. Dec. 15, 2010), 2010 WL 5122380. The government alleged that the defendants conveyed inside information about Advanced Micro Devices' financials, and Apple's sales and purchase forecasts. *Id.*

152 Amended Complaint, SEC v. Longoria, No. 11-CV-0753 (S.D.N.Y. Feb. 8, 2011), 2011 WL 396032.

153 *Id.* The trades were based on material, nonpublic information about AMD, Seagate Technology, Western Digital, Fairchild Semiconductor, and Marvell Technology Group. *Id.*

154 Longoria, Litigation Release No. 22270, 2011 WL 10915929 (Feb. 24, 2012).

155 Press Release, DOJ, Expert-Networking Firm Consultant Sentenced in Manhattan Federal Court to Four Years in Prison for Insider Trading Crimes (Sept. 21, 2011), *available at* http://www.justice.gov/usao/nys/pressreleases/September11/jiauwinifredsentencingpr.pdf. The co-defendants, Samir Barai, a portfolio manager for two different hedge funds, and Son Ngoc

As a consultant, Jiau provided material nonpublic information regarding corporate sales and upcoming earnings to select clients of the firm, including hedge fund managers.[156] The unlawful trades made on the basis of this inside information resulted in illegal profits in excess of $3 million.[157] As compensation for this information, the hedge fund managers paid the expert network firm, who in turn paid Jiau for her consulting services.[158] After a two-week trial, the jury ultimately found Jiau guilty of insider trading and conspiracy.[159] The court sentenced her to four years incarceration and ordered a forfeiture of over $3 million.[160]

The cases against expert network firms and hedge funds exemplify the government's aggressive attempts to combat insider trading. As the Manhattan U.S. Attorney explained, "Jiau conducted herself as though insider trading was a game. [Her] sentence is a stark reminder that it is a crime, not a game, and those who engage in this conduct will be punished."[161] The government's success in prosecuting consultants of hedge funds illustrates that recent interpretations of insider trading laws are broad enough to prohibit selective disclosure of material nonpublic information.

C. *Novel Investigatory Techniques*

Over the course of the last decade, the government has been using novel techniques to investigate financial crimes, including the use of court-authorized wiretaps,[162] whistleblowers,[163] surveillance programs,

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Nguyen, a former senior financial analyst who received information from Jiau, pled guilty. Press Release, FBI, Manhattan U.S. Attorney Announces Guilty Pleas of Former Hedge Fund Portfolio Manager & NVIDIA Fin. Emp. to Insider Trading Charges (May 27, 2011), *available at* http://www.fbi.gov/newyork/press-releases/2011/manhattan-u.s.-attorney-announces-guilty-pleas-of-former-hedge-fund-portfolio-manager-and-nvidia-finance-employee-to-insider-trading-charges.

156 Government's Memorandum of Law in Opposition to Defendants' Motions to Dismiss the Indictment, No. S1 11 Cr. 161 (JSR) (S.D.N.Y. Apr. 22, 2011), 2011 WL 1810178 [hereinafter Government's Opposition].

157 *Id.* Sentencing Memorandum on Behalf of Winifred Jiau, No. S1 11 Cr. 161 (JSR) (S.D.N.Y. Sept. 14, 2011), 2011 WL 4369321, at *12.

158 Government's Opposition, *supra* note 156, at *2.

159 Press Release, DOJ, Expert-Networking Firm Consultant Found Guilty in N.Y. of Insider Trading Crimes (June 20, 2011), *available at* http://www.stopfraud.gov/news/news-0620 2011.html.

160 *See* United States v. Jiau, 734 F.3d 147, 149 (2d Cir. 2013) (affirming the conviction because the evidence was sufficient and the recordings were admissible).

161 Expert-Networking Firm Consultant Sentenced in Manhattan Federal Court to Four Years in Prison for Insider Trading Crimes, *supra* note 155.

162 See *infra* Part II.C.1 for a discussion of secret wiretaps.

163 See *infra* Part II.C.2 for a discussion of whistleblower programs.

and tracking of trades.[164] Traditionally, the SEC investigated insider trading cases by issuing subpoenas for documents, taking depositions, and interviewing witnesses.[165] The SEC can issue subpoenas to firms, individuals, banks, telephone companies, and issuers.[166] Information produced from these sources may include trading, bank and phone records, emails, text messages, and hard drives.[167] Because we live in an electronic world, where the majority of business interactions occur through email and other social media, the government can obtain much more information from these traditional discovery methods than they could even at the turn of the century.[168] However, the SEC has found that these traditional discovery methods are still ineffective to combat securities fraud, and over the last few years have developed novel investigative techniques.

1. Secret Wiretaps

In a recent case against hedge-fund manager Raj Rajaratnam, the government used and relied on secret wiretaps for the first time in an insider trading case.[169] Prior to the Rajaratnam case, wiretapping was generally only used to investigate and prosecute organized crimes, terrorists, and drug cartels.[170] The Omnibus Crime Control and Safe Streets Act, commonly referred to as the "Wiretap Act,"[171] was primarily enacted to "combat organized crime."[172] The Act had a dual purpose—to protect the privacy rights of individuals under the Fourth Amendment and to provide a uniform basis for authorizing the use of wiretaps.[173]

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164 See *infra* Part II.C.3 for a discussion of options exchange surveillance and audit trail systems.

165 United States v. Rajaratnam, No. 09 Cr. 1184 (RJH), 2010 WL 4867402, at *15–17 (S.D.N.Y. Nov. 24, 2010) (discussion of traditional investigative methods used by the SEC in its investigation of Rajaratnam).

166 *Id.* at *16 (listing entities SEC served during its investigation of Rajaratnam).

167 *Id.* (listing the sources of information obtained during the investigation of Rajaratnam).

168 Stephen J. Crimmins, *Insider Trading: Where Is the Line*, 2013 COLUM. BUS. L. REV. 330, 350 (2013).

169 *Rajaratnam*, 2010 WL 4867402, at *22.

170 Andrew P. Atkins, *New Methods of Financial White-Collar Criminal Investigation and Prosecution: The Spillover of Wiretaps to Civil Enforcement Proceedings*, 33 PACE L. REV. 716, 717 (2013).

171 Title III of the Omnibus Crime Control and Safe Streets Act of 1968, 18 U.S.C. §§ 2510–22 (2006) (the statute is often referred to as the "Wiretap Act").

172 United States v. Torres, 751 F.2d 875, 881 (7th Cir. 1985) (quoting S. REP. NO. 90-1097, at 70 (1968), *reprinted in* 1968 U.S.C.C.A.N. 2112, 2157) (internal quotation marks omitted).

173 Peter Murphy, Note, *An Examination of the United States Department of Justice's Attempt to Conduct Warrantless Monitoring of Computer Networks Through the Consent Exception to the Wiretap Act*, 34 CONN. L. REV. 1317, 1321 (2002) (quoting S. REP. NO. 90-1097 (1968), *reprinted in* 1968 U.S.C.C.A.N. 2112, 2153).

Under the Act, the government is authorized to wiretap communications when investigating certain crimes, which do not include insider trading or securities fraud.[174] Rajaratnam, therefore, moved to suppress the government's introduction of evidence obtained from a secret wiretap in his securities fraud trial.[175] The trial court denied the motion and the Second Circuit affirmed, holding that even if wiretaps could not be authorized for the purpose of investigating insider trading, nothing in the Act bars prosecutors from using the fruits of authorized wiretaps to prosecute insider trading.[176] In fact, the Wiretap Act explicitly permits the disclosure and use of wiretap "communications relating to offenses other than those specified in the order of authorization . . . ."[177] Under this reasoning, the government could use wiretapped evidence to prosecute the non-enumerated offense of insider trading, so long as the government initially used the wiretap in good faith to investigate an enumerated offense, such as wire fraud or money laundering.[178]

Given the impact of the tape-recorded conversations during the Rajaratnam trial, the use of wiretaps is a powerful new tool in the government's arsenal of weapons to fight insider trading.[179] It is likely that prosecutors will now aggressively use evidence obtained from authorized secret wiretaps to prosecute insider trading rings.[180]

2. Whistleblower Program

After the financial crises at the turn of the century, the government and the SEC enacted rules to help ease the SEC's and DOJ's burden of detecting, investigating, and prosecuting securities fraud, including insider trading. As example, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 required the SEC to create a whistleblower program that would pay 10% to 30% bounties on information leading to cases with a recovery exceeding $1 million.[181]

174 18 U.S.C. § 2516 (2006) (enumerating offenses that the government could lawfully use a wiretap to investigate).

175 *See* SEC v. Rajaratnam, 622 F.3d 159 (2d Cir. 2010).

176 *Id.* at 173.

177 18 U.S.C. § 2517(5) (2006).

178 *Rajaratnam*, 2010 WL 4867402, at *3–4. Prosecutors charged Rajaratnam with five counts of conspiracy to commit securities fraud and nine counts of insider trading. United States v. Rajaratnam, 802 F. Supp. 2d 491, 495 (S.D.N.Y. 2011).

179 Craine & Kell, *supra* note 78, at 48.

180 Preet Bharara, U.S. Attorney for the S.D.N.Y., Prepared Remarks for U.S. Attorney Preet Bharara: U.S. v. Raj Rajaratnam, et al.; U.S. v. Dainielle [sic] Chiesi, et al. Hedge Fund Insider Trading Takedown (Oct. 16, 2009), *available at* http://www.justice.gov/usao/nys/pressreleases/October09/hedgefund/hedgefundinsidertradingremarks101609.pdf.

181 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 922(a), 124 Stat. 1376, 1841 (2010) (codified at 15 U.S.C. § 78u-6(b)).

The SEC launched this program in 2011, and over the first few years it has been successful in providing tips concerning possible insider trading.[182]

3. Options Exchange Surveillance and Audit Trail System

The SEC also created the Options Regulatory Surveillance Authority (ORSA) in 2006. ORSA monitors options trading for insider trading, conducts investigations, and refers possible wrongdoing to the SEC for investigation.[183] Finally, in 2012, the SEC adopted a rule requiring the exchanges and the Financial Industry Regulatory Authority (FINRA) to establish a "market-wide consolidated audit trail."[184] This system created a single database, including information of trade orders and executions that permits the SEC to reconstruct market events in an accurate and timely manner.[185]

III. Reg FD Is Unnecessary and Has Unintended Negative Consequences

Reg FD was arguably unnecessary from its inception because traditional insider trading laws largely prohibited the conduct it proscribed. Even assuming, however, that Reg FD was necessary at its inception, it is certainly unnecessary today given courts' recent expansive view of insider trading restrictions and the government's ability to use novel investigatory techniques. Moreover, even if the Supreme Court ultimately reverses these decisions, Congress or the SEC could solve the problem through legislation or regulation that focuses on trading, rather than on information flow. That is, Reg FD is superfluous in light of current insider trading law.

Further, empirical studies demonstrate that Reg FD has unintended negative consequences on analysts and retail investors. There is a general consensus in the literature that Reg FD has been successful in achieving the immediate goal of reducing selective

182 SEC, Ann. Rep. on the Dodd-Frank Whistleblower Program 11 (2012), *available at* http://www.sec.gov/about/offices/owb/annual-report-2012.pdf.

183 Press Release, Chi. Bd. Options Exch., CBOE Chosen to Be Regulatory Servs. Provider for New Options Regulatory Surveillance Auth. (Apr. 6, 2006), *available at* http://www.cboe.com/AboutCBOE/ShowDocument.aspx? DIR=ACNews&FILE=20060406.doc.

184 Press Release, SEC, SEC Approves New Rule Requiring Consolidated Audit Trail to Monitor and Analyze Trading Activity (July 11, 2012), *available at* http://www.sec.gov/news/press/2012/2012-134.htm.

185 *Id.*

disclosures[186] and increasing the quantity of voluntary public disclosures.[187] These studies, however, only show that Reg FD is effective, not that it is efficient. The impact that these changes have had on social welfare is more controversial. At least some studies have concluded that Reg FD impairs the functioning of markets by depriving retail investors of a valuable filter that ultimately provides them more accurate, reliable and informative reports than an issuer would ever provide.[188]

A. *Insider Trading Prohibitions Renders Reg FD Superfluous*

1. Reg FD Arguably Unnecessary from Its Inception

Before the promulgation of Reg FD, corporations had engaged in selective disclosure under the apparent protection of *Chiarella*[189] and *Dirks*.[190] Accordingly, analysts or institutional investors would arguably not be liable for trading on material nonpublic information because they do not occupy a fiduciary relationship or some other relationship of trust and confidence with the corporation.[191] Further, selective disclosure of material nonpublic information to analysts or institutional investors would only be prohibited if the insider received a benefit from the disclosure.[192]

Despite this apparent protection, the SEC filed two complaints against corporate insiders for selective disclosure of material nonpublic information to market professionals. In *SEC v. Stevens*, the SEC brought an action against a CEO who informed analysts that his company's quarterly revenues would not meet expectations.[193] These analysts contacted their clients who then sold their stock, avoiding losses of $126,455.[194] The SEC alleged that the CEO was liable under *Dirks* because the CEO received a benefit in the form of an enhanced

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186 *See, e.g.*, Andreas Gintschel & Stanimir Markov, *The Effectiveness of Regulation FD*, 37 J. ACCT. & ECON. 293 (2004).

187 *See, e.g.*, Warren Bailey, Haitao Li, Connie X. Mao & Rui Zhong, *Regulation Fair Disclosure and Earnings Information: Market, Analyst, and Corporate Responses*, 58 J. FINANCE 2487 (2003); Vesna Straser, Regulation Fair Disclosure and Information Asymmetry (March 2002) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=311303.

188 See *infra* Part III.B for a discussion of Reg FD's harmful impact on securities analysts and retail investors.

189 Chiarella v. United States, 445 U.S. 222 (1980).

190 Dirks v. SEC, 463 U.S. 646 (1983).

191 *Chiarella*, 445 U.S. 222.

192 *Dirks*, 463 U.S. at 667.

193 Stevens, Litigation Release No. 12813, 1991 WL 296537 (Mar. 19, 1991).

194 *Id.*

reputation and improved status as a corporate manager.[195] This type of personal benefit could be plausibly pled in virtually any case involving a routine communication of material information to an analyst by an executive who valued his job.[196]

Similarly, in *SEC v. Rosenberg*, the SEC argued that an analyst, who traded for his own account on the basis of selectively disclosed information prior to public disclosure, was liable for insider trading because the failure to disclose constituted a "breach of a duty arising out of a relationship of trust and confidence" owed by the analyst to his firm and the firm's clients.[197] Again, this type of fiduciary relationship could be pled in any case involving analysts who work for clients.

In both cases, consent judgments were filed simultaneously with the complaints.[198] Consequently, the SEC's theory that Section 10(b) and Rule 10b-5 could be used to prosecute selective disclosure remained unreviewed by the courts. Had the SEC taken these cases to trial and prevailed, Reg FD would have been unnecessary, as traditional insider trading laws would proscribe virtually all selective disclosures.[199]

In fact, the SEC recognized the significant overlap between violations of insider trading laws and violations of Reg FD. In Reg FD's promulgating release, the SEC explained:

> Issuer selective disclosure bears a close resemblance . . . to ordinary "tipping" and insider trading. In both cases, a privileged few gain an informational edge—and the ability to use that edge to profit—from their superior access to corporate insiders, rather than from their skill, acumen, or diligence. . . . The economic effects of the two practices are essentially the same. Yet, as a result of judicial interpretations, tipping and insider trading can be severely punished under the antifraud provisions of the federal securities laws, whereas the status of issuer selective disclosure has been considerably less clear.[200]

Accordingly, even in the wake of *Dirks*, which adopted the personal benefit standard, the SEC believed that it was still possible to meet that requirement in cases of selective disclosure.[201] Rather than test this

195 *Id.*

196 Edward H. Fleischman, Comm'r, SEC, Ferreting in the Interstices of S.E.C. Attitudes to Securities Analysts, Presentation to the University of California, San Diego, 18th Annual Securities Regulation Institute (Jan. 24, 1991), *available at* http://www.sec.gov/news/speech/1991/012491fleischman.pdf.

197 Rosenberg, Litigation Release No. 12986, 1991 WL 296668, at *1 (Sept. 24, 1991).

198 *See* Rosenberg, 1991 WL 296668, at *2; Stevens, 1991 WL 296537, at *1.

199 *See* Glen Banks, *The SEC Puts the Weight on the Other Side*, 224 N.Y. L.J. 33 (2000).

200 SEC Release No. 7881, *supra* note 21, at *2 (footnote omitted).

201 *See, e.g.*, Stevens, 1991 WL 296537 (alleging that insider's enhanced reputation by selectively disclosing information to analyst was a personal benefit to the insider); *see also* Proposed Rule: Selective Disclosure and Insider Trading, Exchange Act Release No. 7787, Investment Company Act Release No. 24209, 1999 WL 1217849, at *5 (Dec. 20, 1999) (explaining

possibility and confront the perceived ineffectiveness of insider trading law, the SEC adopted Reg FD. By not treating selective disclosure as a type of fraudulent conduct, the SEC placed selective disclosure outside the purview of Rule 10b-5, and thus outside existing Supreme Court precedents.[202] Instead, the SEC designed Reg FD as an issuer disclosure regulation in accordance with its power under § 13(a)[203] and § 15(d) of the Securities and Exchange Act.[204]

2. Reg FD Certainly Unnecessary Under Recent Interpretations of Insider Trading Prohibitions

In the last two decades with the weakening of the fiduciary duty requirement, and the availability of novel investigatory techniques, the government would almost certainly be able to prosecute selective disclosure resulting in unlawful trading under Section 10(b) and Rule 10b-5.

When the SEC promulgated Reg FD, it was concerned that it may not have been able to successfully prove a breach of fiduciary duty as required under Supreme Court interpretation of insider trading laws.[205] Post-Reg FD case law has established, however, that in certain situations a breach of fiduciary duty is not a required element for insider trading liability.[206] Further, since the enactment of Reg FD, the SEC has been successful in pursuing expert network firms,[207] and the SEC has developed novel investigatory techniques to detect, investigate, and prosecute inside trading.[208]

In fact, the SEC has already been successful in prosecuting selective disclosure under insider trading laws, as depicted by the case against Rajat Gupta. Gupta was convicted of insider trading for leaking

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that although there have been few cases based on disclosures made by or to securities analysts after the personal benefit standard articulated in *Dirks*, such disclosures would be deemed improper if motivated by some personal benefit, such as enhanced reputation).

202 *See* Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,594 (Dec. 28, 1999) (codified at 17 C.F.R. pt. 243) (stating that selective disclosure to market insiders is not synonymous with insider trading and can be regulated by means other than Rule 10b-5 and the Supreme Court's interpretation of that Rule).

203 15 U.S.C. § 78(m)(a) (2012) (granting the SEC the power to require that issuers file certain reports).

204 15 U.S.C. § 78(o)(d) (2012) (granting the SEC the power to require issuers to submit supplementary information).

205 Proposed Rule: Selective Disclosure and Insider Trading, 1999 WL 1217849, at *5 (noting that many commentators have found that the personal benefit test of *Dirks* may provide protection to insiders who selectively disclose material information, and analysts who receive such information).

206 See *supra* Part II.A.3 for a discussion of the gradual erosion of the fiduciary requirement.

207 See *supra* Part II.B for a discussion of expert network cases.

208 See *supra* Part II.C for a discussion of novel investigatory techniques.

boardroom secrets to his friend and business associate, Raj Rajaratnam. Through circumstantial evidence, the government established not only that Gupta stood to personally benefit from his relationship with Rajaratnam, but also that Gupta breached the duty he owed to Goldman investors and fellow directors.[209]

B. *Reg FD's Harmful Impact on Securities Analysts and Retail Investors*

Though empirical data suggests that Reg FD has been successful in achieving the immediate goal of reducing selective disclosure,[210] the regulation may have had some unintended consequences such as reducing the overall flow of useful information and negatively impacting the functioning of market analysts.

Several empirical studies have indicated that the quantity and quality of information has declined since Reg FD was implemented.[211] As example, a survey conducted by the Association for Investment Management and Research (AIMR) concluded that a majority of financial analysts and portfolio managers believe that Reg FD gave companies "an excuse to provide less information to everyone."[212] More than 50% of analysts interviewed believed that companies disclosed less information regarding earnings guidance and forward-looking projections in the post-Reg FD period.[213] The President and CEO of AIMR explained, "[e]veryone has access to the same information at the same time, and that's laudable, but if there is less information in the marketplace, that's lamentable."[214] These sentiments were recently echoed by a chairman of an investment management firm who opined that Reg FD's "restrictions on free speech are not healthy for the functioning of free markets—not on Wall Street, not anywhere."[215]

209 See *supra* notes 6–13 for a discussion of the case against Rajat Gupta.

210 Gintschel & Markov, *supra* note 186, at 293–314.

211 Bailey, Li, Mao & Zhong, *supra* note 187, at 2507.

212 Press Release, CFA Institute, Fair But Not Full Disclosure: Everyone Has Less Information Under Regulation FD, Analysts, Portfolio Managers Say in AIMR Survey (Oct. 18, 2001), *available at* http://cfainstitute.org/about/press/release/Documents/2001_press_releases.pdf.

213 *Id.* (reporting that between 53 and 54% of analysts believed that less earnings guidance was available post-Reg FD and between 43 and 46% of analysts believed that less facts about internal operations, pricing, and sales were available). A similar survey conducted by the National Investor Relations Institute (NIRI) revealed that a distinct minority of investment relation officers decreased communications with investors and analysts after the enactment of Reg FD, providing less information about their firms and meeting less with individual investors or analysts. *See* NIRI, CORPORATE DISCLOSURE PRACTICES SURVEY 5 (2001).

214 *Research Studies Show Differing Views on Regulation FD*, CPA J., Dec. 2001, at 8, *available at* http://www.nysscpa.org/cpajournal/2001/1200/nv/nv2.htm.

215 John Levin, *When the SEC's 'Fair Disclosure' Rules Backfire*, WALL ST. J., Oct. 28, 2014, at A17.

In addition to reducing the overall flow and quality of material information, Reg FD has also made it more difficult for analysts to operate efficiently and accurately. The valuable role that analysts play in securities markets has been recognized not only by scholars and commentators, but also by the Supreme Court and the SEC. Analysts have traditionally interpreted information and disclosed it to the public in a way that individual investors can understand.[216] Analysts presumably meet minimum levels of market proficiency, which is critical to the efficient operation of capital markets.

As the Supreme Court explained in *Dirks*:

> [T]he role of market analysts . . . is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information," 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. . . . 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.[217]

Similarly, the SEC expressly recognized that "[t]he value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors."[218] Before the promulgation of Reg FD, the SEC asserted that analysts should be permitted to obtain from management corporate information for purposes of filling in the gaps in analysis.[219] Even five years after the implementation of Reg FD, the SEC acknowledged the obvious value of analyst reports in providing the market and investors with information about reporting issuers.[220]

Many scholars have explained how "rational" and "intelligent" market participants, such as analysts and institutional investors, are an essential ingredient in the efficient capital market hypothesis

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216 Scott Russell, *Regulation Fair Disclosure: The Death of the Efficient Capital Market Hypothesis and the Birth of Herd Behavior*, 82 B.U. L. REV. 527, 550 (2002).

217 Dirks v. SEC, 463 U.S. 646, 658–59 (1983) (footnotes omitted) (citation omitted).

218 Dirks, Exchange Act Release No. 17480, 1981 WL 36329, at *6 (Jan. 22, 1981); *see also* Laura S. Unger, Acting Chairman, SEC, Speech by SEC Acting Chairman: How Can Analysts Maintain Their Independence? Remarks by Acting Chairman Laura S. Unger U.S. Securities & Exchange Commission at the Ray Garrett Jr. Corporate and Securities Law Institute Northwestern University School of Law Evanston, Ill. (April 19, 2001), *available at* 2001 WL 407157 (quoting Commission decision).

219 Investors Mgmt. Co., Exchange Act Release No. 9267, 1971 WL 120502, at *9 (July 29, 1971).

220 Securities Offering Reform, Exchange Act Release Nos. 8591, 52056, Investment Company Act Release No. 26993, 2005 WL 1692642, at *65 (Aug. 3, 2005).

(ECMH).[221] The ECMH predicts that additional accurate information provided by issuers and analysts would quickly be incorporated into the price of securities, making the price more accurate.[222] The most widely accepted "semi-strong" version of the hypothesis claims both that prices reflect all publicly available information and that prices instantly change to reflect new public information.[223] The more information that is available about a given stock, and the more reliable that information is, the more efficient the capital markets will be at generating the appropriate price for that stock.[224] Permitting issuers to disclose information to analysts that the issuer may not be prepared to share with the public at large, may result in an increase in the timeliness, quality, and quantity of information reaching the market.[225] This information would make the stock prices more accurate which would benefit issuers and investors alike.[226]

Without analysts and sophisticated investors, the ECMH cannot work. Untrained individual investors do not have the requisite acumen to assess information accurately.[227] This failure to accurately assess information would result in a failure of the ECMH because the stock price would no longer reflect the intrinsic value of the corporation. One scholar has warned that without analyst involvement, the ECMH will be replaced by a "herd behavior" model in which irrational individual investors buy and sell based upon whether other irrational investors are buying and selling.[228]

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221 *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FINANCE 383, 404 (1970).

222 The ECMH has generated widespread judicial acceptance. In *Basic Inc. v. Levinson*, the Supreme Court recognized the ECMH when it adopted the "fraud on the market theory" to impose liability on a company for falsely denying merger negotiations. 485 U.S. 224, 224–25 (1988). The Court held that a plaintiff can satisfy the reliance requirement by showing that the market price of the security as a whole was affected by the defendant's misstatement or omission and that the plaintiff suffered a loss due to the transaction at that incorrect price. *Id.* at 247; *see also* Peter J. Dennin, Note, *Which Came First, the Fraud or the Market: Is the Fraud–Created–the–Market Theory Valid Under Rule 10b-5?*, 69 FORDHAM L. REV. 2611, 2619–22 (2001). Since the financial crises at the turn of the century, the theory has been the subject of much critique. *See, e.g.*, David A. Westbrook, *Corporation Law After Enron: The Possibility of a Capitalist Reimagination*, 92 GEO. L.J. 61, 112 n.300 (2003).

223 *See, e.g.*, Fama, *supra* note 221. There are two other versions of the ECMH. The weak version claims that prices on traded assets such as stocks, bonds, or property already reflect all past publicly available information. The strong version also claims that prices instantly reflect even hidden or "insider" information. *See id.* at 383; *see also* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 555–56 (1984).

224 John L. Orcutt, *Investor Skepticism v. Investor Confidence: Why The New Research Analyst Reforms Will Harm Investors*, 81 DENV. U. L. REV. 1, 49 (2003).

225 Stephen J. Choi, *Selective Disclosures in the Public Capital Markets*, 35 U.C. DAVIS L. REV. 533, 541–48 (2002).

226 *Id.*

227 Russell, *supra* note 216.

228 *Id.*

Despite the beneficial role that analysts play in securities markets, Reg FD prohibits corporations from disclosing material information to them without releasing it to the general public. In the only decision to interpret the scope and effect of Reg FD, the court noted the chilling effect that overly aggressive enforcement of the regulation might have.[229] As the court noted, "enforcement of Regulation FD by excessively scrutinizing vague general comments has a potential chilling effect which can discourage, rather than, encourage public disclosure of material information."[230]

Since the enactment of Reg FD, there have been numerous empirical studies conducted considering how its limitations impact securities analysts. When considered collectively, this literature provides evidence that Reg FD has a meaningful negative impact on the accuracy of some analyst products, such as earnings estimates and stock recommendations, and the increased cost of information has resulted in coverage of fewer firms.[231]

One study found that the accuracy of earnings forecasts made by big brokerage analysts declined after the implementation of Reg FD.[232] These well-linked analysts who had superior performance in the pre-FD period are unable to maintain their superiority in the post-FD period.[233] This decreased performance level was a result of these analysts being deprived of a valuable source of common information—managerial disclosures.[234] This conclusion is consistent with another empirical study which found that analysts' earnings forecasts and stock recommendations were less informative after the implementation of Reg FD, as measured by the abnormal stock return volatility around their public release.[235]

A third study documented a general decline in sell-side equity analysts' forecast precision after Reg FD, noting that analyst reports

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229 SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694 (S.D.N.Y. 2005).

230 *Id.* at 708.

231 Mark Bagnoli, Susan G. Watts & Yong Zhang, *Reg-FD and the Competitiveness of All-Star Analysts*, 27 J. ACCT. & PUB. POL'Y 295, 297–98 (2008).

232 Partha S. Mohanram & Shyam V. Sunder, *How Has Regulation FD Affected the Operations of Financial Analysts?*, 23 CONTEMP. ACCT. RES. 491, 519 (2006).

233 *Id.*

234 *Id.* An AIMR survey conducted in early 2000 asked analysts to rank information from private and public sources in order of importance. Spoken word with management was listed as the most important source of information ahead of annual reports, conference calls, and in-house analysis of information. *Id.* at 522 n.5.

235 Gintschel & Markov, *supra* note 186, at 313. The study analyzed a sample of financial analysts' earnings forecasts and stock recommendations. *Id.* at 294 ("[R]eleased between October 23, 1999 and October 23, 2001, [they] show that, [post-Reg FD], the average price impact associated with the dissemination of analysts' information is significantly lower by 28% from the pre-[Reg FD] level." (footnote omitted)).

contain less accurate or useful information.[236] This effect was found both at the individual analyst level and at the level of consensus (i.e., the median across all analysts).[237] The study used a large sample of forecasts made over a nearly ten-year period surrounding the adoption of Reg FD and found that the effect was significantly larger for forecasts made before the beginning of a quarter than for late forecasts,[238] and for smaller companies than for larger companies.[239]

Further, since the implementation of Reg FD, there has been more disagreements, differences of opinion, and forecast dispersions between analysts regarding future projected earnings.[240] This result suggests that Reg FD impairs the ability of financial analysts to reach consensus given the reduced flow of private communications for corporations.[241] As one study demonstrated, the absence of direct, one-on-one communication from company management that can point all analysts to a common earnings per share (EPS) number, results in analysts increasingly arriving at forecasts that are different from each other.[242] As one commentator noted, Reg FD "has made most analysts stock-guessers rather than [stock-]pickers because they do not receive that wink and nod from company management."[243]

In addition to less precision and more dispersion in analyst forecasts, the loss of nonpublic channels of information has caused analysts to expend more effort and money per firm on idiosyncratic information discovery.[244] Due to this increased effort to obtain information for proprietary analysis, individual analysts had to drop coverage of some firms to focus on fewer firms. The study found that in the two years after the implementation of Reg FD, analysts had terminated coverage of 1740 firms while initiating coverage for only 824 firms. Accordingly, there was a significant net decline in analyst

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236 Anup Agrawal, Sahiba Chadha & Mark A. Chen, *Who Is Afraid of Reg FD? The Behavior and Performance of Sell-Side Analysts Following the SEC's Fair Disclosure Rules*, 79 J. BUSINESS 2811, 2822 (2006).

237 *Id.* at 2833.

238 *Id.* The study's point estimate indicates that for a $10 stock, the latest earnings per share (EPS) forecast made by an individual analyst over a two-month period before the beginning of a quarter is about 2.3 cents less accurate post-FD than it was pre-FD. The magnitude of this effect declines significantly—by almost one half—for the latest forecast made over the two-month period before earnings release. *See id.*

239 *Id.* "For firms in the bottom half of [the] sample by market capitalization, the corresponding decrease in EPS forecast accuracy for late forecasts is as much as 4.5 cents compared to only 0.7 cents for firms in the top half of the sample." *Id.*

240 Bailey, Li, Mao & Zhong, *supra* note 187, at 2489.

241 *Id.* at 2505.

242 Agrawal, Chadha & Chen, *supra* note 236.

243 John Tishbi, Comment, *Regulation FD: The Year That Passed and the Years Ahead*, 35 LOY. L.A. L. REV. 1131, 1149 (2002) (alteration in original) (internal quotation marks omitted).

244 *Id.*; *see also* Afshad J. Irani & Irene Karamanou, *Regulation Fair Disclosure, Analyst Following, and Analyst Forecast Dispersion*, 17 ACCT. HORIZONS 15, 18 (2003).

coverage of firms post-Reg FD. Interestingly, one study concluded that analysts dropped coverage of well-followed firms in the post-Reg FD world, and focused on firms receiving less coverage.[245] This suggests that analysts chose to shift coverage to firms where the greater level of effort was likely to yield a competitive advantage over other analysts and where they could differentiate themselves from other analysts.[246] Another study demonstrated that analysts' coverage of smaller firms dropped as a result of Reg FD.[247] With less information in the market about these smaller companies, investors demand a larger premium to invest, increasing financing costs, and resulting in a welfare loss for those firms.[248]

While it may seem unfair that analysts receive information before retail investors, there is no harm to retail investors unless the analysts trade on the nonpublic information. If the analysts merely possess, distill, and then compete to make the information available to the public, they are actually performing a valuable service for retail investors rather than posing a threat to them. Without such selective disclosure, less information is ultimately available to the public. An empirical study has demonstrated that companies are not comfortable releasing vague, longer-term information publicly due to potential legal problems but, prior to Reg FD, were willing to discuss such information privately with analysts since they have expertise to process such information.[249] The effect of Reg FD, therefore, has not been an increase in the amount of information publicly available regarding distant future earnings, but merely a reduction of such information supplied to analysts. "Ultimately, the costs of Reg FD can trickle down to retail investors who depend on professional advisors for investment decisions and information gleaned from the financial media."[250] Rather than focusing on selective disclosure and impeding the valuable functions of analysts, the SEC should focus on the real problem of trading.

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245 Irani & Karamanou, *supra* note 244, at 19, 22. The study found that there was a decrease in the average number of analysts following the most followed firms (15.9 analysts per firm pre-FD versus 15.3 analysts per firm post-FD). In contrast, there was an increase in the average number of analysts following the least followed firms (1.97 analysts per firm pre-FD versus 2.94 analysts per firm post-FD).

246 *Id.* at 17.

247 Armando Gomes, Gary Gorton & Leonardo Madureira, *SEC Regulation Fair Disclosure, Information, and the Cost of Capital*, 13 J. CORP. FIN. 300, 301 (2007) (explaining that the loss of the "selective disclosure" channel for information to be transmitted from firms to markets could not be compensated for via other information transmission channels for small firms).

248 *Id.*

249 Bailey, Li, Mao & Zhong, *supra* note 187, at 2511.

250 *Id.*

IV. Regulation Fair Disclosure: Lawful Restrictions on Speech or Unconstitutional Suppression of Speech

Reg FD not only raises concerns about the effective functioning of capital markets, but also poses serious First Amendment challenges. In a landmark decision, *Central Hudson Gas & Electric Corp. v. Public Service Commission*, the Supreme Court limited the power of the government to prohibit commercial speech.[251] The commercial speech doctrine applies an intermediate level of review to speech that is economic in nature or otherwise has the intent of convincing the listener to partake in a particular transaction.[252] In light of the standard articulated in *Central Hudson*, Reg FD is at least arguably unconstitutional.[253] A recent Supreme Court case, *Citizens United v. FEC*, imposes an even more stringent standard on regulation of political speech.[254] Speech that is political in nature receives the highest level of protection as political deliberation and commentary is recognized as core purposes of the First Amendment.[255] In light of *Citizens United*, many of the disclosures prohibited by Reg FD could qualify as political speech.[256] As a result, the constitutionality of Reg FD is questionable at best.

Government restrictions on the disclosure of truthful non-misleading speech for paternalistic reasons are unlikely to survive a First Amendment challenge. Although the courts have provided no guidance on the constitutionality of Reg FD, the Chamber of Commerce argued that Reg FD was unconstitutional in *SEC v. Siebel Systems*.[257] The defense stressed that Reg FD should be construed narrowly to avoid consideration of the serious First Amendment problems.[258] The court indeed read the statute narrowly, mooting the First Amendment argument.[259] Accordingly, the court seems to have dealt with Reg FD's

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251 447 U.S. 557, 570 (1980) (holding that a Public Service Commission regulation that completely banned promotional advertising by electric utilities violated the First Amendment).

252 *See, e.g.*, Bd. of Trs. of State Univ. of N.Y. v. Fox, 492 U.S. 469, 482 (1989).

253 For a discussion of the four-part standard, see *supra* Part IV.A.1–4.

254 558 U.S. 310, 365 (2010) (holding that the government could not prevent a corporation from using funds to make a political documentary available on cable television).

255 *See* Burt Neuborne, *The First Amendment and Government Regulation of Capital Markets*, 55 BROOK. L. REV. 5, 17 (1989).

256 For a discussion of the strict scrutiny standard applied to political speech, see *supra* Part IV.B.

257 Chamber of Commerce is the nation's largest federation of business companies and associations, representing more than three million businesses. *See* Chamber Amicus Brief, *supra* note 32, at 1–2.

258 Reply in Support of Defendants' Motion to Dismiss the Complaint at 12, SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694 (S.D.N.Y. 2005) (No. 04 CV 5130 (GBD)), 2004 WL 3142266.

259 *Siebel Sys., Inc.*, 384 F. Supp. 2d at 704–08.

potential chilling effect on corporate speech through interpretation, rather than invalidation.[260]

The *Siebel* court implicitly recognized that securities regulations are not exempt from First Amendment scrutiny.[261] The SEC has also recognized that its regulations may be subject to First Amendment review.[262] Many scholars have expressed concern with extending First Amendment protection to securities regulation because striking down such regulation would result in widespread harm to capital markets.[263] This concern is tempered by the fact that most securities regulations would survive First Amendment review.[264] The only provisions which

260 Several other cases raising First Amendment challenges to SEC regulations have also been resolved on other grounds. Each case involved restrictions on the flow of information that was of conceded assistance to hearers in making informed and autonomous choices about capital formation issues. As an example, in *Lowe v. SEC*, the SEC sought to enjoin the publication of an investment newsletter because the author was ineligible for an investment analyst's license. 472 U.S. 181, 183 (1985). There were no allegations that the content of the newsletter was false or misleading. *Id.* at 210 n.58. The Supreme Court avoided the constitutional issue by narrowly interpreting the SEC's licensing power under the Investment Advisors Act of 1940, but stated that "it is difficult to see why the expression of an opinion about a marketable security" should not be protected by the First Amendment. *Id.*

261 The Supreme Court has provided little guidance regarding the First Amendment's application to securities regulation. When the Securities Act was enacted, the Supreme Court had already recognized constitutional rights of corporations, Santa Clara Cnty. v. S. Pac. R.R. Co., 118 U.S. 394, 396 (1886), but had not yet extended First Amendment coverage to corporate speech. First Nat'l Bank of Bos. v. Bellotti, 435 U.S. 765, 784–85 (1978). After the Supreme Court recognized First Amendment protection to commercial speech, an impressive list of commentators, scholars, and practitioners argued that securities regulation was outside the reach of the First Amendment. *See, e.g.*, Frederick Schauer, *The Boundaries of the First Amendment: A Preliminary Exploration of Constitutional Salience*, 117 HARV. L. REV. 1765, 1769–71, 1778–79 (2004); Allen D. Boyer, *Free Speech, Free Markets, and Foolish Consistency*, 92 COLUM. L. REV. 474, 495 (1992) (book review) ("The Court has . . . rejected any implication that the First Amendment should be applied in the securities field."); *see also* Law Professors Brief as Amicus Curiae in Opposition to Motion to Dismiss at 16–22, *Siebel Sys., Inc.*, 384 F. Supp. 2d 694 (No. 04 CV 5130 (GBD)) (signatories are prominent securities professors, including John C. Coffee, Jr., Alan R. Bromberg, James D. Cox, Melvin A. Eisenberg, Jill E. Fisch, Theresa A. Gabaldon, Thomas Lee Hazen, Howell Jackson, Donald C. Langevoort, Ronald M. Levin, Henry Monaghan, Donna M. Nagy, Neil M. Richards, Margaret V. Sachs, Hillary A. Sale, Joel Seligman, Larry D. Soderquist, Marc I. Steinberg, Lynn Stout, Steven Thel, Robert B. Thompson, and William K.S. Wang) (arguing that there was a securities exception from the First Amendment for securities regulation based on dicta from two early cases). Recently, several scholars have demonstrated that there is no reasonable justification for a securities regulation exemption to First Amendment protection. *See, e.g.*, Lloyd L. Drury, III, *Disclosure Is Speech: Imposing Meaningful First Amendment Constraints on SEC Regulatory Authority*, 58 S.C. L. REV. 757, 759–60 (2007); Page, *supra* note 54, at 829–30.

262 *See* Regulation of Communications Among Shareholders, 57 Fed. Reg. 48,276, 48,279 (Oct. 22, 1992) (codified at 17 C.F.R. pts. 240, 249); *see also* Blount v. SEC, 61 F.3d 938, 946–47 (D.C. Cir. 1995) (noting that the SEC maintained loopholes in its regulation because of its "sensitivity" to First Amendment concerns (internal quotation marks omitted)).

263 *See, e.g.*, Boyer, *supra* note 261, at 495.

264 Cases holding that the First Amendment does not protect false or misleading economic speech would remain good law under the commercial speech doctrine. *See, e.g.*, SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 861–62 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). Mandatory disclosure rules would likely survive constitutional review. *See Blount*, 61 F.3d at 938, 944–48

would raise serious free speech concerns are those that prohibit the disclosure of truthful, non-misleading, and sometimes material speech based on paternalistic concerns, such as the Reg FD and the Quiet Period rules.[265] The "'Quiet Period Rules' essentially prohibit the dissemination of both truthful and misleading speech outside of the statutory prospectus filed with the [SEC]."[266]

The communications disseminated by Reed Hastings, the CEO of Netflix, and by Rajat Gupta, a director of Goldman Sachs, provide excellent test cases for analyzing the constitutionality of Reg FD.[267] Hastings posted on his personal Facebook page a statement that "Netflix's monthly online viewing had exceeded one billion hours for the first time."[268] In light of the SEC's recent guidance, this communication would likely violate Reg FD even if the statement was entirely accurate.[269]

Similarly, if Rajat Gupta, a director of Goldman Sachs, was also a senior official of the company, his communications to Raj Rajaratnam would have violated Reg FD. These truthful and accurate communications involved material nonpublic information about Goldman's investments and earnings.[270] Rajat Gupta would have likely been liable for disclosing this information even if there was no trading that resulted from the disclosure, and even though the information was entirely accurate.

A. *Reg FD's Restrictions on Commercial Speech Is Arguably Unconstitutional Under* Central Hudson

Until 1976, the commercial speech doctrine established structural divides between different categories of speech.[271] These divides were based on a speaker-centered model of free speech which focused on the inherent right of the speaker to speak and a "prophylactic refusal to

(upholding Rule G-37 that restricted political contributions by parties involved in the municipal securities market).

265 Susan B. Heyman, *The Quiet Period in a Noisy World: Rethinking Securities Regulation and Corporate Free Speech*, 74 OHIO ST. L.J. 189, 230 (2013) (proposing that the SEC craft regulations to protect investors against false or misleading statements while still respecting corporate speech rights and efficiency in capital markets).

266 *Id.* at 189.

267 See *supra* Introduction and Part I for a discussion of the disclosures made by Gupta and Hastings, respectively.

268 *See* SEC Press Release No. 2013-51, *supra* note 49.

269 After conducting its investigation, the SEC decided not to bring an action against Netflix because the guidance surrounding social media was vague.

270 See *supra* Introduction for a discussion of the disclosures made by Gupta.

271 *See* Valentine v. Chrestensen, 316 U.S. 52, 54 (1942), *abrogated by* Va. State Bd. of Pharm. v. Va. Citizens Consumer Council, Inc., 425 U.S. 748 (1976).

permit the government to decide what speech to tolerate."[272] This model provided significant protection for speech concerning religion,[273] politics,[274] science,[275] or aesthetics,[276] but virtually no protection for speech about consumer choice[277] or labor relations.[278]

In *Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc.*, the Supreme Court abandoned this rigid structural divide and held that economic speech in the area of consumer affairs should be protected.[279] Specifically, the Court found that the right of pharmacists to advertise prescription drug prices was constitutionally protected. This paradigm shift was premised on the belief that hearers had an interest in hearing commercial speech in order to enhance their ability to make an informed choice and to act more efficiently.[280] Although the Court did not set forth a precise standard of review, the Court did hold that commercial speech was subject to less protection than non-commercial speech.[281] Unlike political or religious speech, false or misleading commercial speech could be regulated.[282]

A few years later, in *Central Hudson Gas & Electric Corp. v. Public Service Commission*, the Supreme Court found that New York's attempt to diminish oil consumption by forbidding electric companies from advertising heat was unconstitutional because it was more draconian than necessary.[283] The Court developed a four-part inquiry for determining whether a ban on commercial speech is unconstitutional:

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272 Neuborne, *supra* note 255, at 16. A classic example of the Supreme Court applying a speaker-centered theory of the First Amendment was when the Court found unconstitutional a state injunction preventing a Nazi group from parading swastikas and distributing literature that incited hatred against Jewish people. Nat'l Socialist Party of Am. v. Vill. of Skokie, 432 U.S. 43 (1977).

273 *See, e.g.*, W. Va. State Bd. of Educ. v. Barnette, 319 U.S. 624 (1943) (holding that children cannot be compelled to salute Flag in violation of their religious belief).

274 *See, e.g.*, Hague v. CIO, 307 U.S. 496 (1939).

275 *See, e.g.*, Epperson v. Arkansas, 393 U.S. 97 (1968).

276 *See, e.g.*, Winters v. New York, 333 U.S. 507 (1948) (holding that literature is a protected form of expression).

277 *See, e.g.*, Williamson v. Lee Optical of Okla., Inc., 348 U.S. 483 (1955) (concluding that advertisements for optical care products are not protected speech).

278 *See, e.g.*, Int'l Longshoremen's Ass'n, AFL-CIO v. Allied Int'l, Inc., 456 U.S. 212 (1982) (holding that political boycotts by labor unions are not protected speech).

279 *See* 425 U.S. 748 (1976).

280 *Id.* at 763–64.

281 *Id.* at 770.

282 *Id.* at 771–72.

283 447 U.S. 557 (1980) (holding that a Public Service Commission regulation that completely banned promotional advertising by electric utilities violated the First Amendment). Justice Blackmun, whose concurring opinion was joined by Justice Brennan, believed that if the government wished to deter the use of electric heat or promote energy conservation, it was required do so directly and not through the medium of information control. *Id.* at 579 (Blackmun, J., concurring).

> At the outset, we must determine whether the expression is protected by the First Amendment. For commercial speech to come within that provision, it at least must concern lawful activity and not be misleading. Next, we ask whether the asserted governmental interest is substantial. If both inquiries yield positive answers, we must determine whether the regulation directly advances the governmental interest asserted, and whether it is not more extensive than is necessary to serve that interest.[284]

This four-part analysis continues to serve as the benchmark for whether a regulatory burden on commercial speech violates the First Amendment.[285] Generally, the party seeking to uphold a restriction on commercial speech carries the heavy burden of justifying the restriction.[286]

Because Reg FD seeks to restrict speech that relates to the value of marketable securities, Reg FD regulates commercial speech. The regulation applies only to the communication of corporate information between an issuer and persons who are likely to have an interest in whether to buy or sell the issuer's securities, such as analysts and institutional investors.[287] The SEC has argued that "[t]he issuer is interested in communicating with these persons for essentially one reason—to induce them to purchase or retain the company's securities, or recommend the same to investors."[288] If communications by issuers in this context are considered commercial speech, Reg FD would arguably be deemed unconstitutional under the four-prong test outlined in *Central Hudson*.

1. Reg FD Regulates Protected Speech

To determine the constitutionality of Reg FD under the *Central Hudson* test, a court must determine—as a threshold matter—whether the communications were untruthful or misleading. Assuming the statements made by Hastings and Gupta were factually accurate, the SEC may argue that the information was nonetheless misleading because it contained incomplete information that could unduly influence investment decisions. However, it does not appear that this

284 *Id.* at 566 (majority opinion).

285 U.S. CONST. amend. I (relevant notes of decision citing several recent cases referring to the *Central Hudson* test).

286 *See Cent. Hudson Gas & Elec. Corp.*, 447 U.S. 557.

287 SEC Selective Disclosure and Insider Trading Rule, 65 Fed. Reg. 51,716, 51,718 (Aug. 24, 2000) (codified at 17 C.F.R. pts. 240, 243, 249).

288 Plaintiff Securities and Exchange Commission's Opposition to Motion to Dismiss the Complaint at 24, SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694 (S.D.N.Y. 2005) (No. 04 CV 5130 (GBD)), 2004 WL 3142263 [hereinafter SEC Opposition Brief].

information would mislead the investors to whom Reg FD applies—institutional investors or market analysts. In fact, the very nature of the harm caused by Reg FD lies in the fact that the statements are true and accurate. Otherwise, there would be no advantage to having the information before the general public. Further, even if some irrational investors could unduly rely on this information, the mere potential for deception would not justify a categorical suppression of speech.[289] Rather, such potentially misleading speech could only be suppressed if the restriction was appropriately tailored and satisfied the remaining prongs of the *Central Hudson* test.[290] Accordingly, under *Central Hudson*, the release would not be false or misleading unprotected speech.

2. The Government Interest Is Likely to Be Deemed Substantial

The next step would be to determine whether the proffered government interests in enacting Reg FD are substantial.[291] The SEC has announced that the regulation was adopted to further its twin goals of "'preventing the use of inside information for trading of securities' and 'preserving confidence in the markets . . . .'"[292] Interestingly, Reg FD is expressly not aimed at preventing fraud, deception, or curing any public misinformation. As the SEC explained, Reg FD is "not an antifraud rule" and selective disclosure is not a type of fraudulent conduct.[293]

Although the broad purposes the SEC seeks to advance are obviously substantial, "the question is not whether the *general* purposes of securities law are compelling; rather, it is whether the purposes of *this* regulation are."[294] Accordingly, the inquiry should focus on identifying the problem the SEC claims to be addressing and the magnitude of that alleged problem.[295]

The SEC asserts that the problem of selective disclosure is substantial because such disclosures are common and harmful to the public.[296] However, the severity of this problem is not well supported by

289 *See* Peel v. Attorney Registration & Disciplinary Comm'n of Ill., 496 U.S. 91, 100 (1990) (holding that while inherently misleading speech may be prohibited entirely, potentially misleading speech may not be categorically suppressed unless the character or the statements creates a state interest sufficiently substantial to justify a categorical ban on their use).

290 Edward T. Highberger, Note, *Not So Fast! Scrutinizing the "Gun Jumping" Provisions of the Securities Act Under the Commercial Speech Doctrine*, 83 NOTRE DAME L. REV. 2141, 2169 (2008).

291 *Cent. Hudson Gas & Elec. Corp.*, 447 U.S. at 566.

292 SEC Opposition Brief, *supra* note 288.

293 *See* SEC Release No. 7881, *supra* note 21, at *19.

294 Chamber Amicus Brief, *supra* note 32, at 16.

295 *Id.*

296 *Id.*

empirical data.[297] In its adopting release, the SEC relies on selected news reports and staff perceptions, and discounts contrary evidence that more companies are opening up conference calls to the public.[298] In different contexts, the Supreme Court has questioned "the State's interest in full disclosure" and has determined that "the danger the State posits is not as great as might initially appear."[299] "In the absence of a more substantial showing . . . such a generality is . . . too remote to furnish a constitutionally acceptable justification for the deterrent effect on free speech which this all-embracing ordinance is likely to have."[300] Despite these potential arguments, a court would likely find that the government has a substantial interest in regulating selective disclosure.

3. Reg FD Does Not Directly Advance the Governmental Interest

Since the first two inquiries would likely yield positive answers, *Central Hudson* requires analysis of "whether the regulation directly advances the governmental interest asserted."[301] A court is more likely to strike down Reg FD due to its weak relation to the SEC's interest than because of any finding as to the strength of that interest.[302] The SEC would not be able to satisfy this burden "by mere speculation or conjecture; rather, the [SEC] must demonstrate that the harms it recites are real and that its restriction will in fact alleviate them to a material degree."[303] This burden would be difficult to satisfy as it is not clear that Reg FD "directly advances" the goals of preventing unfair trading and preserving the integrity of the market, since it extends to speech that is entirely unrelated to trading.[304] The problem is that the SEC's interests depend not on selective disclosure in isolation, but rather on trading that may result from the selective disclosure.

The mere fact that some investors or analysts possess more information than others is neither surprising nor objectionable.

297 *Id.*

298 SEC Selective Disclosure and Insider Trading Rule, 65 Fed. Reg. 51,716, 51,717–18 (Aug. 24, 2000) (codified at 17 C.F.R. pts. 240, 243, 249).

299 Riley v. Nat'l Fed'n of the Blind of N.C., Inc., 487 U.S. 781, 798 (1988) (holding that North Carolina licensing and disclosure requirements for professional fund raisers was unconstitutional).

300 Talley v. California, 362 U.S. 60, 66–67 (1960) (Harlan, J., concurring) (holding as an unconstitutional abridgment of the freedom of speech and of the press a city ordinance prohibiting the distribution of handbills—in any place under any circumstances—that did not have the names and addresses of the persons who prepared, distributed, or sponsored the handbills printed on them).

301 Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n of N.Y., 447 U.S. 557, 566 (1980).

302 *See generally* Eugene Volokh, Essay, *Freedom of Speech, Permissible Tailoring and Transcending Strict Scrutiny*, 144 U. PA. L. REV. 2417, 2421 (1996).

303 Greater New Orleans Broad. Ass'n, Inc. v. United States, 527 U.S. 173, 188 (1999).

304 Chamber Amicus Brief, *supra* note 32, at 13–14.

Investors or potential investors, however, may lose confidence in the markets when they believe that others are trading on this informational advantage.[305] Without the subsequent trading, there is no advantage to be gained from receiving material nonpublic information. As example, the drastic price increase of Goldman's stock before the public release of positive earnings reports might have caused investors to lose confidence in the market. The price increase was a result of Rajaratnam's funds purchasing Goldman's stock based on the nonpublic information, not the mere possession of the information itself.[306] Curtailing the trading that results from selective disclosure is, therefore, the way to directly advance the state's interest, rather than curtailing the mere disclosure.[307] Reg FD provides only "ineffective or remote support for the government's purpose," and is, therefore, constitutionally infirm.[308]

4. Reg FD Is More Extensive than Necessary to Serve the Governmental Interest

Whatever the strength of the SEC's evidence to justify Reg FD, the regulation would likely not satisfy the final step of the *Central Hudson* analysis. The critical inquiry in a case challenging Reg FD will be whether the government can demonstrate that the regulation is not more expansive than is necessary to serve its interest.[309] "If the [g]overnment can achieve its interests in a manner that does not restrict commercial speech, or that restricts less speech, the [g]overnment must do so.[310]

Reg FD is not appropriately tailored as it extends to general business matters unrelated to securities. Though the SEC has argued that the "material nonpublic" qualifier limits the regulation's reach to instances where it is "reasonably foreseeable" that the recipient will trade on the information,[311] such a result is unclear. A wide variety of general business information may fit within the definition of material.[312] The SEC has used a "radical prophylactic approach" to speech—banning

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305 Chiarella v. United States, 445 U.S. 222, 242 (1980) (explaining that the duty to disclose under the insider trading rules is premised on the inherent unfairness of allowing individuals to trade on the basis of material nonpublic information); *see also* Page, *supra* note 54, at 789.

306 Analysts make profits at the expense of investors by selling before negative information is released to the public and buying before favorable information is released. Dugar & Nathan, *supra* note 41, at 18.

307 To prevent analysts from profiting at the expense of investors, most brokerage firms have adopted strict policies prohibiting analysts from trading on their own accounts. *See id.*

308 Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n of N.Y., 447 U.S. 557, 564 (1980).

309 *Id.*

310 Thompson v. W. States Med. Ctr., 535 U.S. 357, 371 (2002).

311 SEC Opposition Brief, *supra* note 288, at 22.

312 Chamber Amicus Brief, *supra* note 32, at 14.

material speech to a select few or requiring the material speech to be publicly disclosed.[313]

Further, Reg FD is not appropriately tailored as it extends to speech that does not result in any trading activity. The government can achieve its twin purposes of preventing the use of inside information for trading of securities and preserving confidence in the markets[314] by only targeting speech that results in trading, rather than targeting any material disclosure. Despite the fact that trading is the only source of potential harm that might result from selective disclosure, Reg FD targets the transmission of information, rather than any trading on that information. This regulation, which solely targets speech, acting either to compel it to the public, or suppress it from private audiences, therefore, raises serious First Amendment concerns and would likely not withstand First Amendment scrutiny if challenged.

B. *Reg FD's Restrictions on Political Speech Is Unconstitutional Under* Citizens United

While *Central Hudson* imposed significant restrictions on the government's ability to restrict commercial speech, the opinion did not reach political speech. It was not until 2010, in *Citizens United v. FEC*, that the Supreme Court imposed meaningful restrictions on the government's ability to regulate political speech of corporations.[315] The Court held that corporations engaging in political speech are entitled to the same First Amendment protection as individuals.[316] Although directed at political speech, the broad language undercuts one of the basic premises of the commercial speech doctrine—that corporations engaging in speech relating to economics are entitled to less protection than individuals engaging in more valuable speech. Accordingly, *Citizens United* may ultimately undermine *Central Hudson* for commercial speech as well, because the thrust of the opinion is to reduce the disparity in treatment between commercial and political speech. *Citizens United* also suggests that Reg FD may ultimately be subject to a strict scrutiny review, as the current rules would prevent corporations

313 *See* Susan Lorde Martin, *Insider Trading and Rule 14e-3 After* Chestman, 29 AM. BUS. L.J. 669, n.22 (1992) ("[I]nsider traders appropriate returns on corporate investments rightfully due incumbent outsider shareholder and that dampens shareholder support."). The harm caused by insider trading is thus not the mere possession of the information but the fact that those in possession of material nonpublic information trade on the basis of that information soon before its public release, thus recognizing significant profits or avoiding significant losses. *Id.*

314 SEC Opposition Brief, *supra* note 288, at 22.

315 Citizens United v. FEC, 558 U.S. 310 (2010).

316 *Id.*

from selectively disclosing any material information, including information with a political impact.

The case involved Citizens United, a nonprofit corporation that planned to release a ninety-minute documentary entitled *Hillary: The Movie*, within thirty days of the 2008 primary elections.[317] The film criticized Hillary Clinton, a candidate in the Democratic Party's presidential primary elections.[318] Concerned that the release would violate § 441b of the McCain-Feingold Act and §§ 201 and 311 of the Bipartisan Campaign Reform Act of 2002 (BCRA), Citizens United sought declaratory and injunctive relief against the Federal Election Commission (FEC).[319] The Supreme Court concluded that the FEC could not prevent Citizens United from using funds from individuals and for-profit corporations to make a "documentary" about Hillary Clinton available on cable television.[320]

In finding the § 441b prohibition to be facially unconstitutional, Justice Kennedy equated the constitutional dignity of corporations to that of natural persons.[321] Corporations enjoy the same right to speech as individuals because "[s]peech restrictions based on the identity of the speaker are all too often simply a means to control content."[322] Like individuals, corporations and other associations are participants in the marketplace of ideas.[323] Political speech is "indispensable to decisionmaking in a democracy, and this is no less true because the speech comes from a corporation rather than an individual."[324] Accordingly, restrictions on corporate political speech should be subject to the same strict scrutiny review as restrictions on individual core speech.[325] Under this standard, the government must show that the restriction "furthers a compelling interest and is narrowly tailored to achieve that interest."[326]

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317 *Id.* at 319, 321.

318 *Id.* at 319–20.

319 *Id.* at 321. *See generally* Darrell A.H. Miller, *Guns, Inc.: Citizens United, McDonald, and the Future of Corporate Constitutional Rights*, 86 N.Y.U. L. REV. 887 (2011).

320 *Citizens United*, 558 U.S. at 349–50.

321 *Id.* at 339 ("If [BCRA] applied to individuals, no one would believe that it is merely a time, place, or manner restriction on speech. Its purpose and effect are to silence entities whose voices the Government deems to be suspect.").

322 *Id.* at 340.

323 *Id.* at 342–43. ("Corporations and other associations, like individuals, contribute to the discussion, debate, and the dissemination of information and ideas that the First Amendment seeks to foster." (quoting Pac. Gas & Elec. Co. v. Pub. Util. Comm'n of Cal., 475 U.S. 1, 8 (1986) (plurality opinion) (internal quotation marks omitted)).

324 *Id.* at 349 (quoting First Nat'l Bank of Bos. v. Bellotti, 435 U.S. 765, 777 (1978)).

325 Matthew A. Melone, Citizens United *and Corporate Political Speech: Did the Supreme Court Enhance Political Discourse or Invite Corruption?*, 60 DEPAUL L. REV. 29, 73 (2010) ("[L]aws that burden political speech are subject to strict scrutiny . . . ." (internal quotation marks omitted)).

326 FEC v. Wis. Right to Life, Inc., 551 U.S. 449, 464 (2007); *see also* Eu v. S.F. Cnty. Democratic Cent. Comm., 489 U.S. 214, 223 (1989) ("[T]he First Amendment has its fullest and

Although some speech captured by Reg FD may involve explicit promotions of securities, Reg FD may also reach fully protected speech, which will have little, if any, promotional implications. "Material nonpublic" information may not only include statements with an economic impact, but may include statements with a political impact as well. For example, an issuer such as Netflix may insert a political message into its communication. Doing so would change otherwise "commercial speech" into "political speech" or "mixed speech." Given that Reg FD would likely not survive scrutiny under the *Central Hudson* test, it certainly has little chance to survive if challenged under the strict scrutiny standard of the political speech doctrine.[327] The *Citizens United* Court stated conclusively that "[n]o sufficient governmental interest justifies limits on the political speech of . . . corporations."[328] Given this broad language, a court would likely find that Reg FD affecting such a wide range of speech, including truthful speech, is not narrowly tailored to achieve the government's twin purposes of preventing the use of inside information for trading and preserving investor confidence in the securities markets.[329] Other less restrictive measures to the broad prophylactic restrictions currently in place are available.[330]

The Facebook posting by Hastings would likely be characterized as commercial speech as it relates to the potential value of securities.[331] In order to receive the heightened protections afforded to political speech, Hastings could have used a different tactic to enhance Netflix's image. For instance, Hastings could have posted information about Netflix taking a popular political stance—similar to Nike speaking out against sweatshop labor.[332] This type of speech would probably be characterized as "mixed speech" as it involves both a political and a commercial message. Empirical evidence suggests that increased corporate political activity increases firm performance and profits.[333]

Assuming Hastings, in violation of Reg FD, posted on his Facebook page that Netflix had taken a popular political stance, a strict scrutiny level of review under *Citizens United* would apply, rather than a lesser standard under *Central Hudson*. Under strict scrutiny, the government

most urgent application to speech uttered during a campaign for political office." (internal quotation marks omitted)).

327 *Citizens United*, 558 U.S. at 347–52.

328 *Id.* at 365.

329 SEC Opposition Brief, *supra* note 288.

330 *See infra* Part V.

331 *See supra* Part III.A.

332 Another example of political speech is Nike speaking out against sweatshop labor or Toyota encouraging consumers to fight global warming. *See* Deborah J. La Fetra, *Kick It Up a Notch: First Amendment Protection for Commercial Speech*, 54 CASE W. RES. L. REV. 1205 (2004) (discussing the difficulties in drawing lines between political, commercial, and mixed speech).

333 *See* Sean Lux et al., *Mixing Business with Politics: A Meta-Analysis of the Antecedents and Outcomes of Corporate Political Activity*, 37 J. MANAGEMENT 223, 239 (2011).

would have to demonstrate that the offering restrictions "further[] a compelling interest and [are] narrowly tailored to achieve that interest."[334] The SEC would likely be able to establish that it has compelling interests in preventing the use of inside information for trading of securities and preserving confidence in the markets.[335] However, the government would probably not be able to set forth sufficient evidence to demonstrate that the broad prophylactic selective disclosure rules, which indiscriminately restrict speech regardless of whether it results in any trading activity, are narrowly tailored to achieve its compelling interests. As the government would probably not be able to demonstrate a "reasonable fit" between the means and the ends of the regulatory scheme under *Central Hudson*, it would be virtually impossible to meet the higher "narrowly tailored" standard under *Citizens United*. Further, there are several less restrictive means of achieving the government's objectives.

The restrictions placed on issuer communications may be subject to a strict scrutiny level of review even without the insertion of a political message. Although directed at political speech, *Citizens United* may ultimately result in the abandonment of the commercial speech doctrine as formulated by *Central Hudson*.[336] *Citizens United* radically affirmed the principle that the First Amendment must be neutral as between different speakers, holding that even corporate speech (at least on political matters) is fully protected by the First Amendment and cannot be subject to increased regulation merely because of its corporate authorship.[337] Accordingly, the basis for treating commercial speech differently must be its content, not its corporate authorship.[338] Above all, the Court made clear that it takes seriously that the First Amendment is meant to safeguard the "marketplace of ideas" with all its "free market" connotations.[339] The Court also rejected as a basis for legislation the notion that the government should address the market power of large corporations within the "marketplace of ideas."[340]

In the decade leading up to *Citizens United* some commentators had already argued that the distinction between commercial speech and more protected speech was becoming less important as the Supreme

334 FEC v. Wis. Right to Life, Inc., 551 U.S. 449, 464 (2007) (citation omitted). "The First Amendment has its fullest and most urgent application to speech uttered during a campaign for political office." Eu v. S.F. Cnty. Democratic Cent. Comm., 489 U.S. 214, 223 (1989).

335 SEC Opposition Brief, *supra* note 288.

336 Darrel C. Menthe, *The Marketplace Metaphor and Commercial Speech Doctrine: Or How I Learned to Stop Worrying About and Love* Citizens United, 38 HASTINGS CONST. L.Q. 131 (2010).

337 Citizens United v. FEC, 558 U.S. 310, 363–64 (2010).

338 *Id.*

339 *Id.* at 349–50.

340 *Id.* at 349.

Court was becoming more protective of commercial speech.[341] In a series of commercial speech cases related to liquor,[342] gambling,[343] tobacco,[344] and prescription drugs,[345] the Supreme Court found the speech limitations unconstitutional. The level of review for commercial speech cases appears to have moved closer to strict rather than intermediate scrutiny.[346]

V. INVALIDATING OR REPEALING REG FD IN LIGHT OF NORMATIVE AND CONSTITUTIONAL CONCERNS

Reg FD is at best a roundabout way of addressing the SEC's core concern with insider trading: use of information by a small class of investors who profit at the expense of the general public.[347] The SEC's core concerns could be addressed more effectively in a variety of ways. First, the SEC could repeal Reg FD in light of the normative and constitutional concerns. Alternatively, Congress or the SEC could enact fraud-based legislation or regulation that focuses on trading, rather than on information flow. Finally, the Supreme Court might bring the issue to a head by invalidating Reg FD as an unlawful suppression of speech.

The SEC could repeal Reg FD and still prohibit analysts and their clients from trading on selectively disclosed information before disclosing it to the public. This can be done through vigorous enforcement of Section 10(b) and Rule 10b-5.[348] These anti-fraud laws, which target the wrongful trading that results from selective disclosure, rather than the selective disclosure itself, would resolve some of the normative and constitutional concerns.[349] Unlike Reg FD, the anti-fraud laws are not more extensive than necessary to serve the government's

341 *See, e.g.*, Eugene Volokh, Essay, *Freedom of Speech and Intellectual Property: Some Thoughts After* Eldred, 44 Liquormart, *and* Bartnicki, 40 HOUS. L. REV. 697, 732 (2003) ("[The Court] has been providing more and more protection [to commercial speech] since the early 1990s."); *see also* Developments in the Law, *VI. Free Speech Protections for Corporations: Competing in the Markets of Commerce and Ideas*, 117 HARV. L. REV. 2272, 2272 (2004) ("[C]ommercial speech has enjoyed greater protection in recent years . . . .").

342 44 Liquormart, Inc. v. Rhode Island, 517 U.S. 484, 489 (1996).

343 Greater New Orleans Broad. Ass'n, Inc. v. United States, 527 U.S. 173, 176 (1999).

344 Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 553 (2001).

345 Thompson v. W. States Med. Ctr., 535 U.S. 357, 360 (2002).

346 *See, e.g.*, Menthe, *supra* note 336; Note, *Making Sense of Hybrid Speech: A New Model for Commercial Speech and Expressive Conduct*, 118 HARV. L. REV. 2836, 2853–56 (2005).

347 Russell, *supra* note 216, at 552.

348 Riley v. Nat'l Fed'n of the Blind of N.C., Inc., 487 U.S. 781, 795 ("In striking down this portion of the Act, we do not suggest that States must sit idly by and allow their citizens to be defrauded. North Carolina has an antifraud law, and we presume that law enforcement officers are ready and able to enforce it.").

349 NAACP v. Button, 371 U.S. 415, 438 (1963) ("Broad prophylactic rules in the area of free expression are suspect. Precision of regulation must be the touchstone in an area so closely touching our most precious freedoms." (citations omitted)).

twin goals of preventing the use of inside information and preserving investor confidence in the securities markets.[350] Also, the anti-fraud laws would not prevent issuers from selectively disclosing to analysts for them to filter and interpret the information before disclosing it to the public, so long as there was no unlawful trading based on the information.

Although the SEC adopted Reg FD because of the perceived ineffectiveness of insider trading laws, post-Reg FD case law has established that the anti-fraud laws could be used to prosecute selective disclosure that results in unlawful trading. In fact, the SEC has relied on Section 10(b) and Rule 10b-5 to prosecute such selective disclosure cases as demonstrated by the case against Rajat Gupta.[351] Further, the government's ability to use novel investigatory techniques since the enactment of Reg FD has eased its burden of investigating and prosecuting insider trading violations.

Alternatively, Congress or the SEC could enact fraud-based legislation or regulation that focuses on trading, rather than on information flow. The advantage of this approach over relying on Section 10(b) and Rule 10b-5 is that the legislation or regulation could clarify the fiduciary duty and personal benefit requirements of existing Supreme Court precedent.[352] The SEC's general counsel indicated that the SEC would have the authority to extend the *Dirks* benefit test to apply to trading that resulted from disclosures benefitting the issuer.[353]

Rather than repealing Reg FD and enacting another regulation, the SEC could revise Reg FD to include unlawful trading as a required element of a violation. With this revision, the SEC would no longer be able to target the mere transmission of information. Instead, it would only be able to prosecute disclosures resulting in unlawful trading.

Finally, the Supreme Court might bring this issue to a head by invalidating Reg FD as an unlawful restraint on speech in violation of the First Amendment. The Court could also clarify the fiduciary duty and personal benefit requirements to ensure that issuers engaging in selective disclosure that results in trading would be covered by the insider trading laws. As the Court explained in *Dirks*, the focus should be on "policing insiders and what they do . . . rather than on policing information per se and its possession . . . ."[354]

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350 See *supra* Part IV for a discussion of the First Amendment.

351 See *supra* notes 6–13 for a discussion of the *Gupta* case.

352 Antony Page & Katy Yang, *Controlling Corporate Speech: Is Regulation Fair Disclosure Unconstitutional?*, 39 U.C. DAVIS L. REV. 1, 79 (2005).

353 *Panel Discussion: The SEC's Regulation FD*, 6 FORDHAM J. CORP. & FIN. L. 273, 279 (2001).

354 Dirks v. SEC, 463 U.S. 646, 662–63 (1983) (alterations in original) (internal quotation marks omitted).