Directors and Officers Securities Litigation Loss Prevention

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for Chubb

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Introduction

Claims under the federal securities laws present the greatest exposure for directors and officers of publicly traded companies. If a material upward or downward movement in a company's stock price is perceived to be caused by surprising disclosures, litigation will likely be filed alleging that the company and its responsible directors and officers improperly delayed disclosure of that surprising information or otherwise misled the investing public. Investors who traded in the company's stock during the period the information was allegedly withheld or misrepresented may claim they were damaged to the extent that the stock price when they traded was different from what the stock price would have been if proper disclosure of the information had been made.

Virtually all securities litigation against directors and officers is based upon alleged violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. It is tempting to believe statutes that old are now fully developed through case law and regulations, and their meaning and requirements are well understood by companies and legal practitioners. Unfortunately, reality is far different. Courts in securities litigation are constantly issuing new and at times conflicting interpretations of these statutes and are applying these statutes to an ever-changing business environment. Plus, significant new federal legislation has been enacted in recent years–most notably the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010–which impose additional disclosure requirements for publicly-held companies. Because of this changing legal framework and the potentially catastrophic liability exposure created by many securities class action lawsuits, directors and officers, with the assistance of experienced advisors, need to thoroughly understand their legal duties under these laws and implement effective loss prevention practices in this area.

Directors and officers cannot avoid securities litigation altogether. A sophisticated plaintiffs' bar has become quite skilled at creating persuasive allegations of wrongdoing, and courts have broadly interpreted many aspects of the federal securities laws. However, a well-conceived, fully implemented securities litigation loss prevention program can reduce the likelihood and severity of such litigation. Such a program can also significantly reduce the civil or criminal penalties imposed on a company found to have violated the securities laws.

Assuring compliance with the securities laws does not just reduce liability exposure. Effective disclosure is good business. Credibility with shareholders, analysts, and the financial community benefits a company in the long run. In addition, full compliance with the securities laws helps preserve a company's hard-earned reputation for maintaining the highest legal and ethical standards.

A fundamental goal of an effective securities litigation loss prevention program is to make a company's directors and officers who are involved in disclosure matters realize that improper disclosures can result in severe personal and corporate consequences–both financial and otherwise. With that realization, the directors and officers likely will be more cautious, will seek expert advice more readily, and will apply basic common sense in formulating cautious disclosure philosophies.

This booklet presents a number of specific practices that can be followed to reduce this important liability exposure. Many of these practices are simply common sense, although some reflect the counterintuitive nature of certain aspects of the securities laws. It is important to note that the statements and advice that follow are derived in large part from our observations of what many companies do to manage their securities litigation risk. But, "best practices" in this area evolve rapidly based on ever-changing case law, statutes and regulations, as well as new developments relating to the capital markets, Internet/social media, cybersecurity and climate change, among other factors. No booklet can describe procedures or policies that will fit every company's situation, nor should any company be expected to adopt all of the procedures discussed herein.

General Securities Law Compliance

The fundamental goal of the federal securities laws, and thus the primary goal of a securities law loss prevention program, is the full, accurate, and timely disclosure of material information. The following 17 guidelines encompass the basics of an effective loss prevention program, as well as the foundations of good corporate disclosure practices.

Establish the proper disclosure culture
Since the adoption of the Sarbanes-Oxley Act of 2002, the business environment surrounding corporate disclosure has profoundly changed. Today, disclosure control adequacy–once primarily the domain of internal and external counsel and certain specified individuals inside the organization–is now a subject to which senior management must devote considerable attention. Senior managers must realize that they are responsible for setting the tone from the top for ethical behavior in deciding what information to disclose or withhold from the investing public. They must realize that they are personally responsible for assessing and managing the company's exposure to risk and ensuring an adequate system of disclosure controls. They must provide appropriate resources and authority to effectively maintain the company's system of disclosure controls and must support compliance programs that remedy past offenses and prevent their reoccurrence. This process requires the active involvement of the CEO and CFO. In the end, demonstrating and demanding ethical behavior with respect to all of the company's disclosure policies is one of senior management's most important goals.

Tell the Truth

Although telling the truth seems like a given, it may not be as self-evident as one would expect. Senior management must establish a corporate culture that clearly and unequivocally mandates only truthful, forthright internal and external communications. As part of this culture, management should not tolerate clever "spin." At times, it is tempting to prefer an alternative to complete disclosure because the truth may negatively affect the company's stock price. That temptation must be denied. Communications should be easy to understand, and convey the whole truth. Even unsophisticated investors should be able to readily understand the disclosed information.

Use "no comment" responses

A policy of truthful disclosure does not mean that a company is required to answer every question posed to it. Naturally, information that is either confidential or not ripe for public release should be closely protected. The SEC, courts, and securities exchanges recognize that a company may properly avoid premature public disclosure of certain types of information if there is a valid business reason for withholding it. In these cases, "no comment" is an appropriate response to an inquiry. To be useful, however, the "no comment" response must be used in a consistent way. A company that normally denies false rumors, but issues a "no comment" response to an inquiry about a particular rumor may, in essence, be confirming the rumor. (See page 41 for further discussion about rumors.)

Employ a coordinated team approach
No one person or department can fully satisfy securities law disclosure requirements. Rather, an integrated team of outside professionals and company representatives must work together, each with clearly defined responsibilities. Fueled by the explicit encouragement of the SEC, many companies have formal disclosure committees. However the team is titled, it should be responsible for 1) ensuring that the company's disclosure controls are sufficiently well-designed and implemented to collect the necessary information to satisfy its public disclosure requirements, 2) assessing the materiality of all information made known to it, 3) considering the proper time and manner of disclosing such information and, 4) where necessary, improving the process by which information is internally collected and analyzed. Inadequate internal communications frequently lead to inadequate disclosures to the investing public.

To ensure that the realities of the company's business and marketplace are accurately reflected in disclosed information, the disclosure team should include at least one businessperson familiar with the company's industry and operational environment who can review each disclosure to ensure that it properly reflects that environment. It may also be appropriate for the disclosure team to consist of the principal accounting or financial officer, the general counsel (or principal outside counsel, as appropriate), the head of investor relations, and/or the principal risk manager. However, the disclosure team should not become so large that the group becomes unmanageable. Frequently, well-functioning disclosure teams meet regularly for drafting sessions, both with and without outside advisors. During these meetings, the disclosure team should function principally in a review-and-oversight function.

Follow a regimen for each disclosure

Each disclosure can create potential liability concerns for the company. Therefore, the company should establish and follow a regimen for each type of disclosure. Although that regimen may differ depending on the type of disclosure, no deviations from that defined regimen should occur. The company must craft each of its disclosures with great care.

As part of a good regimen, some companies have developed internal checklists. Some (although certainly not all) of the important items on such a checklist include:

- Is there a reasonable basis in fact for each of the statements made? Has the company documented that basis in its disclosure library?
- Is each statement made in good faith?
- Are the statements consistent with prior statements and internal forecasts?
- Is the level of disclosure made consistent with other disclosures made in the marketplace?
- Are certain statements attributed to persons outside the organization? If so, are consents necessary or advisable?
- Have all internal and external approvals been obtained?
- Does the disclosure implicitly or explicitly impose a duty to update? If so, can that duty be mitigated?
- Does the disclosure properly take full advantage of the legal protections for forward-looking statements? (See page 16.)
- To the extent the disclosure is made outside of a filing with the SEC, should it be filed with the SEC in a Form 8-K?
- Has the stock exchange (or automated quotation system) on which the stock trades been properly advised of the material event disclosed?

No single checklist can be all-encompassing. However, to the extent one is created, it will generally ensure that a company's internal disclosure regimen is more consistently followed.

Delegate duties, not responsibility
Although companies typically delegate many aspects of the disclosure process to lower management or outside professionals, senior management is responsible for establishing and maintaining disclosure controls and procedures that are designed to ensure that information required to be disclosed is in fact recorded, processed, summarized, and reported on a timely basis. This includes controls and procedures designed to ensure that information required to be disclosed by the company in the reports that it files with the SEC is accumulated and communicated to the CEO and CFO, or persons performing similar functions, as appropriate to timely allow decisions regarding required disclosure. Ultimately, the effectiveness of these disclosure controls and procedures must be evaluated and certified by these managers. Accordingly, senior management should personally review all securities law filings and disclosure statements to assure themselves that the company has taken reasonable steps to accurately and completely disclose all relevant material information.

Make disclosures detailed
The more specific and detailed a disclosure is, the more likely it will satisfy investors and the courts. Vague or veiled references to negative information invite false expectations by investors and therefore serve little benefit.

Avoid exaggerated disclosures
Disclosure of good news should not be overly touted, and disclosure of negative news should not be downplayed. A company should resist the temptation to maintain or unduly increase investor confidence at the risk of issuing misleading disclosures. Appropriate restraint in disclosing good news and openness in disclosing negative news builds long-term credibility and helps prevent unreasonable expectations.

Use experienced company spokespeople
Communicate disclosures through a relatively small number of clearly identified company spokespeople who are experienced and educated in disclosure and investor-relations issues. Articulate this policy to all of the company's employees so that they understand how to respond to all inquiries. The more people who are talking on behalf of a company, the greater the chance for inconsistent, inaccurate, or inappropriate company disclosures. Similarly, the chain of command for approval of written or oral disclosures should be well-defined and relatively short so that decisions can be made quickly if necessary. (See pages 31 and 35 for further discussion of disclosure issues.)

Listen to internal skeptics
A company's disclosure decision makers should not casually ignore skeptics within the company who warn management of actual or potential problems. Such warnings may be correct. If a culture exists in which people are writing memos designed to cover themselves because management refuses to listen, potential "smoking guns" are created that may become problematic in subsequent litigation.

To the extent possible, all persons involved in the disclosure process should sign off on the final version of the disclosure before it is released. Nevertheless, because it is unrealistic to expect that all issues involving public statements will be resolved without disagreement or debate, the company should formulate a process for resolving all such disagreements that relate to significant or fundamental disclosure items. In this manner, the company will proactively foster an environment of open communication and discourage an environment of senior management override (thus negating the effectiveness of the disclosure team) by ensuring that all points of view are appropriately evaluated. This procedure could involve submission of certain issues to the audit committee or the entire board of directors, as appropriate.

Educate key people

Company officers, directors, and key employees should be informed about the disclosure obligations of a publicly traded company and their individual roles in those disclosures. As discussed below, this education should also include their personal obligations and limitations with respect to trading in the company's securities.

Certifications of accurate disclosures

By statute, the CEO and CFO of a company must participate in the preparation of the company's annual and quarterly SEC reports and must personally certify both participation and the accuracy of the financial information contained in those reports. The CEO and CFO should document their active involvement in revising those reports and should receive written sub-certifications from other individuals who provide information to confirm the accuracy of those reports. These sub-certifications do not eliminate the need for the CEO and CFO certifications, but can prove the reasonable due diligence of the CEO and the CFO in approving the reports.

Monitor disclosure trends
Closely examine the disclosure documents of similarly situated companies to determine how they address common concerns. If other companies are disclosing a certain level of information, an implication may be created that such information is material and should be disclosed by companies like yours.

Continually evaluate need to update disclosures
A company does not have a duty to disclose material information unless there is a specific legal requirement to do so, such as in SEC filings or in connection with the offering of company securities. However, under some circumstances, a duty may exist to promptly update prior disclosures which are no longer accurate based on subsequent developments. A company should continually evaluate the need for such updated disclosures and promptly make the updated disclosure, if required.

Focus on providing a steady "progression of disclosure"
A company usually has ample warning that material nonpublic information is developing. Oftentimes, changes to the company's industry, business, financial condition, and competitive strength are foreshadowed to management or develop gradually over time. In these cases, management should provide a steady progression of disclosure that seeks to accurately describe not only the current situation, but also the factors that are reasonably expected to have a material impact on the company's operations in the future. Disclosure of this nature will evolve over time and will demonstrate the truly fluid nature of the relevant issues. As part of this process, management may wish to monitor the investment expectations of investors. If company management detects that those expectations are diverging from reality,

appropriate corrective disclosure may be suitable even if such disclosure is not otherwise required. Timely advance disclosure of potentially troubling information or trends, thus resulting in a gradual decline in stock price, makes a company unattractive as a target of shareholder litigation.

Implement document retention policies

A company should maintain, in one readily accessible file, final copies of its press releases, analyst reports, public filings, and relevant news stories so one can always determine what the current mix of public information is with respect to the company. This mix of information should be reviewed periodically to ascertain whether prior company disclosures have become stale, inaccurate, or misleading with the passage of time and whether it is appropriate for affirmative new disclosures to correct or update those prior disclosures. In addition, backup documents should be retained that prove the basis for company disclosures and the resolution of disclosure issues that were identified and addressed.

A document control program should define the procedures for retaining documents and actions of the board, including financial and legal documents, personnel records, and other files relating to the corporation. Procedures for periodic document reviews should be established to conform with state laws and evidentiary rules and determine retention/destruction.

Retain experienced legal counsel

Securities law compliance presents complex, judgmental, and evolving issues that can result in catastrophic liability exposure if not properly addressed. It is critical that a company retain and follow the advice of independent legal counsel who is highly experienced in this specialized area of the law and who demonstrates the highest standards of integrity. In addition, many companies have concluded that experienced in-house counsel is also necessary to ensure that one person, intimately familiar with the company, is, at all times, monitoring the affairs of the company and the constantly evolving legal requirements, standards, and practices applicable to it. In each case, counsel should be capable of both guiding the company through the securities law minefield and convincing, where necessary, company executives and employees of the advisability of changing their practices and attitudes in order to create a safer securities environment.

Forward-Looking Statements

Particularly difficult liability issues arise with respect to disclosure of "forward-looking" or "soft" information such as revenue, earnings, or loss projections; discussions of plans and objectives; and statements of future economic performance. If forward-looking statements prove incorrect, securities holders may claim that the company and its directors and officers illegally misled them. Except in the case of certain types of prospective information required as part of a company's Management Discussion & Analysis of Financial Condition & Results (MD&A) discussion,the federal securities laws generally impose no obligation upon a company and its directors and officers to disclose forward-looking information. However, in many instances, failure to discuss management's expectations may result in a negative response from the investment community and greater volatility in stock prices because market analysts are poorly informed. Thus, both disclosing and failing to disclose forward- looking information can lead to securities claims against directors and officers. For that reason, a well-conceived policy regarding when and how forward-looking information is disclosed by a company can be an important part of a company's securities litigation loss prevention program.

Varying degrees of statutory and judicial protection exists for forward-looking statements if the statements are accompanied by sufficient cautionary language. These defenses seek to lessen the chilling effect that securities litigation can have on the willingness of companies to advise investors of the companies' informed expectations.

The scope and effect of the statutory safe-harbor for forward-looking statements continues to be assessed by courts, and the judicially created defense (known as the "bespeaks caution" defense) varies significantly among courts. As a result, no universal formula exists to assure compliance with the elements of this defense. The following procedures, however, should help a company reduce its exposure in connection with forward-looking statements.

Written Statements

Clearly identify the disclosure as a forward-looking statement

Investors should be informed that the disclosure is a forward-looking statement and not a statement of actual fact. Simply using verbs like "project," "plan," or "expect" may not be sufficient. Likewise, a single, "global" statement indicating that everything in the disclosure that is not historical is forward-looking, may also be insufficient. Instead, a specific, express recognition that a particular statement is forward-looking should be included, thereby invoking the appropriate mental discount factor. Various methods exist for communicating this focused disclaimer. To be effective, the method selected should not leave any doubt that the specific statement is intended to be forward-looking.

Distinguish forward-looking statements from historical fact

Carefully distinguish forward-looking statements from historical facts. For example, a press release stating that the company expects results of the current quarter to equal or exceed those of the preceding quarter should state clearly whether the statement is based on interim operating results for the quarter or is only based on somewhat more vague expectations. If a press release or other disclosure clearly does not contain any forward-looking statements (either explicitly or by implication), a company may wish to eliminate the use of a forward-looking cautionary statement, since the inclusion of such a statement could be used to demonstrate either 1) that the company did not closely tailor the use of such statements to its disclosures or 2) that the company, in fact, intended to make a forward-looking statement.

Prominently disclose general disclaimer and cautionary statements

Any forward-looking statement should be accompanied by a general disclaimer that actual results may materially differ and that the forward- looking statement may not accurately predict the future depending on various risks and uncertainties. In addition, the general disclaimer and cautionary statement warnings should be prominent and easy for investors to locate and understand. These warnings, or at least references to the warnings, should appear near each forward-looking statement. Including warnings in one document does not excuse leaving them out in a later document that contains the same forward-looking statement. Further, the general disclaimer should state that the company does not intend to update forward-looking statements.

Include meaningful cautionary statements
The forward-looking statement should be accompanied by specific, substantive cautionary language that identifies important factors that could cause actual results to differ materially from those predicted. Boilerplate warnings are generally not effective and should be avoided. Instead, tailor the cautionary language to the specific forward-looking statement. Specific events, developments, or other factors that may cause the prediction to not be realized should be identified. As a guiding principle, the SEC has stated that a risk factor is not sufficiently specific if it could be added to another company's disclosure document with little or no modification. The more specific the cautionary language, the better the chances of avoiding liability.

Disclose the existence, likelihood, and magnitude of risk
The cautionary language should disclose information sufficient to permit an investor to determine not only the existence of various risks, but also the likelihood that the risk factor will occur and the magnitude of potential loss or consequence to the company should it occur. For example, if one identified risk factor is the possible inability to obtain regulatory approval for a new product, the disclosure should include information regarding potential impediments to approval and the likely effect on the company should it be forced to move forward with its current product mix.

Disclose any underlying assumptions
If a forward-looking statement is based on certain assumptions, those assumptions should also be disclosed and analyzed.

Include a cautionary statement
It may not be practical to include detailed cautionary statements in press releases, especially brief ones. However, every press release should include at least an abbreviated cautionary statement and general disclaimer. Simply referring to another public document that contains a cautionary statement is insufficient. Similarly, use of a standard cautionary statement that is not tailored to the specific information in the press release is insufficient.

Oral Statements

Identify the disclosure as a forward-looking statement and make a general disclaimer
Like written forward-looking statements, oral forward-looking statements should be identified as such and accompanied by a general disclaimer. For example, a webcast with analysts and others could start with the following introduction:

> "Certain of the matters we will be discussing today [including matters related to potential revenue and earnings growth in future periods, possible product enhancements, and anticipated strategy changes] consist of forward-looking statements. As such, they are subject to the risks and uncertainties that we discuss in detail in our reports filed with the SEC, including our Form [number] for the [quarter/year] ended [date]. Actual results may vary materially. In particular,

we note that [revenues and earnings are affected by a number of factors, including the effectiveness of our marketing strategy, the product offerings of our competitors…]. Further, [product enhancements are affected by the availability of additional funds for research and development…and whether and to what extent we modify our current strategy is dependent upon such items as the acceptance of current products…].”

In addition to this introductory statement, the speaker should identify each specific forward-looking statement as such and make additional cautionary statements where possible.

Reference the location of detailed cautionary statements
Unlike written forward-looking statements, oral statements can refer the audience to other public documents to describe the meaningful risk factors. The speaker should state that additional information concerning factors that could cause actual results to differ materially from those in the forward- looking statement is contained in a specifically identified written document that is readily available and that sets forth a meaningful cautionary statement as described above.

Avoid unplanned statements
Discussions with the press and analysts should be carefully planned and closely follow information prepared in advance. Executives should resist the temptation to “wing it” when asked about future events. For this purpose, many companies find a script (including responses for anticipated questions) to be useful. With the SEC’s adoption of Regulation FD on selective disclosure (see page 31), it is more important than ever to avoid

unplanned oral exchanges that may reveal nonpublic material information.

Do not guess

Oral statements are particularly susceptible to innocent misstatements because of their fluid nature. When in doubt, do not give details and do not guess.

Forward-Looking Statements in MD&A

Certain SEC filings by a company must include disclosures commonly known as Management's Discussion and Analysis of Financial Condition and Results of Operations, or "MD&A." Among other items, the SEC expects these disclosures to clearly identify, discuss, and analyze known trends, events, demands, commitments, and uncertainties that are reasonably likely to have a material effect on future financial condition or operating performance. Although these topics inherently involve forward-looking information, the disclosure of this information is mandatory, unlike the optional disclosure of other types of forward-looking statements. Specifically, a company is required to disclose forward-looking information related to material known trends and uncertainties (to be distinguished from potential trends). This disclosure must provide enough information so that investors are able to ascertain the likelihood that past performance is indicative of future performance. As an example, if the period-to-period comparison set forth in the MD&A reveals a material decline in sales, it may be necessary to reveal not only the underlying causes of the decline, but also whether such causes may negatively affect sales in future periods. As with other forward-looking information, care should be taken to ensure that the protections afforded by appropriate cautionary statements are added to all MD&A disclosures.

Dealing With Analysts

How to properly deal with securities analysts is one of the most difficult issues under the federal securities laws. No one set of rules is clearly correct or preferred over another. Therefore, a company, working closely with qualified securities counsel, should devote considerable time and thought to a desirable program under the circumstances and then aggressively implement, monitor, and enforce that program.

Here are a number of suggestions to consider when formulating such a program.

Ensure compliance with securities laws
Communications with analysts potentially violate several different securities laws, including laws which prohibit insider trading, selective disclosures and manipulative conduct. (See pages 31 - 35 for a discussion of selective disclosure prohibition and pages 55 - 58 for insider trading prohibition) As a result, every communication with analysts should be consistent with detailed procedures approved by securities counsel.

Establish guidelines for reviewing analyst reports
When possible, senior company managers should refuse to comment on draft reports from analysts in order to avoid any implication that the company has endorsed or adopted the statements therein. If the company feels compelled to comment on draft reports, it should establish a standardized process to minimize the risk that the company will be deemed to have adopted the report. Company guidelines regarding the review of draft reports should include the following:

- Limit corrections to historical factual matters that have previously been announced or are clearly immaterial.
- Refuse to comment on any conclusions, opinions, predictions, or recommendations for their accuracy or consistency with internal information.
- Maintain a record of all corrections or comments made.
- Require that every analyst whose report is reviewed be given, not later than when the company's comments are given to the analyst, a written statement that the company 1) limits its review to factual materials, 2) does not comment on the appropriateness of any conclusions, opinions, predictions, or recommendations, and 3) refuses to allow attribution of any information in the report to the company.
- Do not provide copies of an analyst's report to third parties, and do not link to analysts' reports through the company's Internet site (see pages 36 - 43).

Limit reactions to analyst forecasts

In light of the uncertainty over the extent of liability exposure in this area, the plaintiffs' advantage of hindsight, and the serious risk of selective disclosure, it is safest if, when asked to comment on projections by analysts, the company spokesperson makes a statement substantially as follows: "As a matter of policy, the company does not comment on the projections of others." Similarly, it is generally inappropriate to express "comfort," indicate whether a particular projection is "within the anticipated range," or otherwise react, albeit subtly, to the forecasts of others.

If the company decides it is appropriate to comment on the forecasts of analysts, it should do so only in press releases or other widely disseminated written disclosures and should do so in a manner consistent with the discussion in the preceding chapter regarding forward-looking statements.

Carefully time the company's analyst contacts
Sometimes the mere timing of conversations with analysts can increase the risk of litigation. For example, holding such a conversation shortly before the company discloses material new information creates the possible appearance that the new information was prematurely leaked to the analyst. Therefore, it is best to avoid contact with analysts in periods shortly before major announcements. If any conversations with outsiders do occur during such periods (for example, after approximate quarterly results are known internally, but have not yet been announced), limit those conversations to clear factual information not related to the results or events to be announced, and maintain a detailed record of the matters discussed.

Monitor the content of discussions with analysts
A company should focus any discussions with analysts on information that is already publicly available in SEC filings or press releases. Most companies ensure through SEC filings and press releases that information important to analysts is in the public domain. The company's written disclosures should provide ample material for its oral communications with the investment community. In light of Regulation FD (discussed below), one person should be responsible for analyzing the statements made to determine whether additional disclosure should be broadly disseminated immediately following the discussion.

Use extra care when contemplating an offering
Extreme caution is required whenever a company is contemplating, or in registration for, a public offering. This is particularly true for communications with analysts while an offering is being contemplated, since the timing of such communications may raise strong concerns about improperly conditioning the market for the offering–an activity commonly known as "gun-jumping." The SEC has stated that an issuer may be considered to be "in registration" at least from the time an issuer reaches an understanding with the managing underwriter with respect to the offering.

In theory, public presentations, interviews, and meetings with analysts that have been planned well in advance of the company's decision to make an offering will generally not raise concerns. Unfortunately, such meetings with analysts are very likely to give rise to questions about the company's capitalization, liquidity, or similar issues that cannot easily be answered adequately without either referring to a planned offering or risking material omission by failing to refer to a planned offering. While the company is "in registration," it should conduct only regularly scheduled discussions with analysts (e.g., regular open telephone conferences concerning quarterly results) and respond to unsolicited inquiries from analysts on factual matters only. All press releases and contacts with analysts while the company is "in registration" should:

- Be consistent with past practices as to the number, scope, and geographic reach of such releases and contacts
- Avoid any "hype" that might be construed as conditioning the market, especially forecasts of results or opinions concerning values

Deal effectively with market rumors

The law generally does not require a company to comment on market rumors, regardless of whether they are correct or incorrect, unless they are attributable to the company. Unless the company is the source of a rumor, a consistent "no comment" policy may be best. If the company does comment on market rumors, it must do so truthfully and not on a selective basis. By responding, a company may create a new duty to update or correct information contained in the company's response and may create an implication that subsequent rumors to which the company does not respond are truthful. (Note: "The company knows of no reason for the movement in our common stock price" is not the same as "The company does not comment on common stock trading activity." The former statement can imply a duty to update if knowledge does become available.) The principal exchanges request issuers to respond promptly to rumors in some instances where the rumor results in heavy market activity. For example, the Nasdaq Stock Market states, "It may also be appropriate, in certain circumstances, to publicly deny false or inaccurate rumors that are likely to have, or have had an effect on the trading in its securities or would likely have an influence on investment decisions."

Establish and observe company spokesperson procedures

Because of the difficulties regarding contacts with analysts, it is wise to establish specific procedures in this area. First, have all inquiries from analysts directed to one person or department; make sure all other personnel know that they are not allowed to discuss material, nonpublic information with anyone. The designated spokespeople should be thoroughly trained in legal issues relating to communications with analysts and should be able to "think on their feet" since many unexpected situations will arise in this area. As a further precaution, limit access to information that is likely to have an effect on trading in company securities (e.g., information concerning earnings, mergers and acquisitions, and changes in dividends) to those with a need to know.

Procedures should be in place to assure that company executives advise the spokesperson of all major developments so that he or she does not unknowingly make false or misleading statements. It is also advisable that the spokesperson adopt a uniform practice, when confronted with a major inquiry, of responding: "Company policy is that we do not respond to such inquiries without internal review. I will attempt to respond to you by [time]." Thus, the spokesperson reserves sufficient time to confirm information internally, formulate a careful response, and determine if a public announcement should be made in advance of further discussion with the analyst. The response time may be hours or days depending on the nature of the inquiry. Such a procedure will only be effective if 1) the policy statement is made consistently and routinely, and 2) the response is delayed even if the spokesperson is confident of the response. Otherwise, the very fact of delaying the response will send a signal to the inquirer.

Have the spokesperson join in executive interviews and presentations
Occasionally, an analyst may wish to interview company executives other than the designated company spokesperson. In such instances, it is advisable that the company spokesperson (who is familiar with appropriate procedures in dealing with analysts) still participate in those interviews in order to steer the discussion away from any information that should be avoided. This

procedure will also assure that the spokesperson is aware of all disclosures made. The executive should be instructed to pause briefly before answering questions so that the spokesperson can interrupt if necessary to avoid inappropriate disclosures.

For similar reasons, the designated spokesperson should also review drafts of all material prepared by the company for distribution to analysts or for presentations at meetings of analysts.

Keep a record of conversations
Because there may later be disputes about the substance of conversations with analysts, it is advisable to maintain a log of such conversations with notations or internal memoranda about the subjects covered and information conveyed. It is also advisable to keep copies of all disclosures, press articles, and reports by analysts concerning the company in a set of binders or similar files, so that the information is well-organized and readily available. This will allow management and company spokespeople to be up-to-date and familiar with the information that is available to the public.

A company should not distribute a transcript of analyst conference calls externally without adding appropriate cautionary language to it. The oral disclaimer by the company at the beginning of an analyst conference regarding forward-looking statements and the reference to risk factors in SEC filings are sufficient to invoke the Private Securities Litigation Reform Act protections for oral forward-looking statements, but it may be insufficient when applied to written forward-looking statements. Distribution of a transcript may convert the oral disclosures to a written disclosure, and thus may eliminate the safe-harbor protection.

Identify the source of any purchased reports
If a company pays an analyst to write a report about the company, the report should disclose that fact and the amount of consideration paid by the company, even if the report is distributed directly by the analyst and not the company.

Selective Disclosure

Selective disclosure is the practice of disclosing information to one or more third parties prior to full dissemination of that information to the marketplace through press releases or other public disclosures. Typically, selective disclosure situations arise when directors and officers discuss corporate information with analysts and institutional investors before the information is released generally to the investing public. That practice is largely prohibited by Regulation FD.

Regulation FD eliminates selective disclosure by requiring that whenever a company (or certain persons acting on its behalf, including its senior management) discloses material nonpublic information to securities market professionals or holders of the company's securities who could be reasonably expected to trade on that information, the company must:

- Simultaneously provide such information to the general public if the disclosure was intentional
- Promptly provide such information to the general public if the disclosure was unintentional

Under Regulation FD, generally, information is "material" if there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision. The following types of information are frequently considered material (depending on the circumstances) and are therefore subject to Regulation FD:

- Earnings information
- Mergers, acquisitions, tender offers, or significant changes in assets
- New products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a contract)
- Change in ownership control or in management
- Changes in auditors or auditor notification that the company may no longer rely on an auditor's report
- Significant events regarding the company's securities (e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of investors, or public or private sales of additional securities)
- Bankruptcy or receivership proceedings

Regulation FD applies to disclosures by a company's senior management, its investor relations professionals, and others who regularly communicate with market professionals and security holders on behalf of the company. In addition, the regulation only applies to disclosures to securities professionals (such as those affiliated with broker-dealers, investment advisors, certain institutional investment managers, investment companies, and hedge funds) and shareholders of the company to the extent it is reasonably foreseeable that such persons will trade on the information. The regulation generally does not apply to communications with the media, with other insiders, or with customers or suppliers in the ordinary course of business. In addition, the regulation expressly excludes communications with the following groups of persons:

- Temporary insiders who owe the company a duty of trust or confidence, such as attorneys, accountants, or investment bankers
- Any person who expressly agrees to maintain the information in confidence
- Any entity whose primary business is the issuance of credit ratings, provided the information is disclosed solely for the purpose of developing a credit rating and the company's ratings are publicly available

For unintentional selective disclosures, Regulation FD states that the "prompt" subsequent disclosure to the general public must occur within 24 hours after the unintentional disclosure or before commencement of the next day's trading on the New York Stock Exchange (NYSE), whichever is later. For example, if a senior official discovers an unintentional selective disclosure of material nonpublic information after the close of markets on Friday, the company will have until the beginning of trading on the NYSE on Monday to widely disseminate that information to the general public.

If public dissemination of information is required, the regulation permits public disclosure by issuing a news release, by filing the information with the SEC, or by other methods that are reasonably designed to provide broad public access without excluding members of the public. A online posting, without more communication, is unlikely to be sufficient because it may not reach the entire public.

Importantly, Regulation FD does not provide a private right of action to shareholders or others if it is violated.

However, the SEC can bring an administrative, civil, or enforcement action alleging violation of the regulation. In addition, violations of the regulation presumably can be used by plaintiffs in class actions as evidence of the defendants' allegedly manipulative conduct in connection with the disclosure of material information about the company.

The SEC offers the following guidance as a model for a company's compliance with Regulation FD:

1. Issue a press release, distributed through regular channels, containing the information. If a company is not widely followed, management should also file an SEC Form 8-K to ensure public dissemination.
2. Provide adequate public notice, by a press release and/or website posting, of a scheduled conference call to discuss the announced results. Give investors both the time and date of the conference call and instructions on how to access the call.
3. Hold the conference call in an open manner, permitting investors to listen either by telephonic means or online. The SEC suggests that issuers should consider providing a means of making the information available for "a reasonable period of time" after the meeting. Many companies include a transcript or audio replay of the conference on their Web sites for this purpose.

Finally, senior managers who participate in the conference call should be well-informed regarding the nature and extent of information already disclosed to the public and should not disclose additional material information in the analysts' conference call. Instead, those calls should limit themselves to explaining the publicly disclosed information and putting it into context, rather than disclosing new material information.

Outside of a violation of Regulation FD, selective disclosure of material nonpublic information can create liability for the participating directors and officers under several theories, including illegal insider trading and illegal manipulative conduct in connection with the purchase or sale of securities. Critical facts that will affect the directors' and officers' potential liability include: to whom the information is selectively disclosed (i.e., whether it is reasonable to assume that the recipient of such information will use it for personal or client gain); what is disclosed (i.e., the materiality of the information and the degree to which it is considered "hard," factual information versus "soft," qualitative comments); and when the information is disclosed (i.e., the proximity and time between the selective disclosure and the full public disclosure by the company).

Emerging Areas of Specific Disclosure Concerns

Companies now face new and challenging disclosure issues in several emerging areas, including the internet and social media, cybersecurity and global warming. The following summarizes many of the disclosure concerns in each of these areas, as well as proactive measures to address these concerns.

Internet and social media disclosures

Traditional notions regarding securities law compliance continue to evolve in response to the use of the internet as the preferred means of communication by companies and shareholders. In addition, the widespread popularity of different types of social media heightens the risk of inaccurate, inappropriate or illegal disclosures about a company by its employees or others. Managing these risks should be a major focus of any securities litigation loss prevention program.

The SEC's enforcement efforts in policing securities law violations through use of the internet and social media are significant. But, as a practical matter, the SEC can monitor only a small portion of the myriad communications occurring daily on the internet. Thus, the public (including professional plaintiff lawyers and investors) are the most likely source of allegations against a company and its directors and officers for securities violations in this area. Despite the tremendous amount of information and communications constantly being made available to the public now, it is reasonably likely that someone will recognize a securities law violation based on internet or social media content if such a violation occurs. Effective loss prevention practices in this area are critical.

To some extent, securities loss prevention concepts in this area need not be new. However, those traditional loss prevention concepts should be supplemented with specialized practices in this area, many of which are summarized below.

Websites

Websites present both opportunities and challenges for companies seeking to communicate timely information to, and create positive relationships with, shareholders. The following procedures should minimize a company's risk of securities law violations through use of a website.

Distinguish between current and dated information
A website continuously makes information available to investors and others for as long as the information appears on the website. Thus, information that has been on the website for some time may appear to be fresh information to a shareholder who accesses the information months

after its publication. To reduce the risks associated with the continuous publication of stale information on a website, a company should follow these practices:

- Include a prominent disclaimer on the website stating that various items of information speak as to a specific date of issuance and may become outdated.
- If any press releases are included on the site, all press releases (good and bad) should be included and maintained identically.
- Older information on the website should be placed in a separate, clearly identified "archive" section with an appropriate disclaimer that the information is dated and will not be updated. Not all information should be archived, though. For example, a company should permit shareholder access to replays or transcripts of analyst conference calls for only a short period of time after the conference call (e.g., 7-10 days).
- A designated compliance officer should periodically review the entire website to ensure that all information remains current and accurate.
- Each section of the website should contain an indication of when that section was last updated.

Manage the content
Website content is often prepared by different company departments, each trying to communicate to a different target audience. All information and statements on the website should ultimately be subject to an internal review and approval by a qualified compliance officer to assure that all disclosures included on the site are accurate, complete, and appropriate, much like the pre-approval for any company press release. With respect to information intended primarily for investors, a separate section of the website should be developed, labeled, and carefully monitored for accuracy, completeness,

and timeliness. Further, like all communications by the company, management should ensure that the information on the Web site is consistent with the disclosures made in the company's filings with the SEC. No safe harbor exists for puffing, exaggerated claims or inappropriate disclosures simply because the statement is made on the website.

Use hyperlinks with caution

By linking to other sources of information, a company's website may be deemed to be adopting or endorsing the content of that other information, and thus the company and its directors and officers may become liable for misrepresentations in those other materials. One safe practice is not to provide links to analyst reports. If the company strongly desires some reference to analyst reports, its website could list the names of all analysts known to follow the company, without providing a hyperlink to any analyst's website or reports. The analysts should be listed in alphabetical or chronological order in order to avoid the appearance that the company favors any one over others. If links to analysts are deemed necessary, provide the link in an objective fashion without drawing distinctions between favorable and unfavorable reports. Such links should be accompanied by a disclaimer stating that the company does not endorse or adopt third-party statements or forecasts and assumes no responsibility for ensuring that they remain up-to-date and accurate. The disclaimer should be located so that it will be seen before the analyst reports are viewed. Any identification of analysts should also include a prominent link to the company's own risk disclosures, so that the statutory safe harbor applicable to forward-looking statements arguably applies if the company is deemed to have adopted an analyst's report or estimates.

To reduce concerns arising from links to analyst reports, some companies link to "consensus estimates," which are websites maintained by outside service providers that compile the estimates of several analysts. Arguably, this practice reduces liability exposure because 1) the estimates revealed are selected by an independent source, 2) no individual estimate is revealed, only a consensus, and 3) shareholders, who demand this type of information, could obtain it easily anyway. However, hyperlinks of this nature still present many of the problems potentially applicable to direct links to analyst reports and therefore should either be avoided or used with the same precautions discussed above.

Avoid "gun-jumping" activities
Companies are prohibited from offering to sell securities before filing a registration statement with the SEC. A company may not prime the market for an impending securities offering by releasing information that alerts the public to the possibility of a securities offering or otherwise arouse investor interest in a prospective offering ("gun-jumping"). As a result, information contained on a company's website and any links to analyst reports and other information must be very carefully controlled while a company is preparing and conducting a securities offering. It is customary for the SEC to review a company's Web site in connection with its review of the registration statement. Although the company may continue its customary disclosure of company news and developments during that time period if the information is unrelated to the offering, it should avoid any statement regarding the company's financial performance or value during this period. Furthermore, to the extent that a company's website contains an interactive feature permitting, for instance, customers to pose questions directly to a senior executive of the company, the company should disable this feature until the registration

statement becomes effective. Care should be taken to ensure that all company descriptions on the website at the time of the first filing of the registration statement closely mirror those contained in the registration statement itself.

Link disclosure to disclaimer
For several reasons, companies should accompany most disclosures with an appropriate disclaimer. For example, disclosures of forward-looking statements should be accompanied by meaningful cautionary statements in order to qualify for safe harbor protection under the securities laws. It is unclear whether a link to a disclaimer page is sufficient for this purpose. Preferably, the disclaimer should appear on the main page of the company's Web site, as well as on any sections of the site that are intended primarily for investors, thus assuring that the investor will see the disclaimer.

Protect oral transcripts
If a company elects to include a transcript of oral statements (such as analyst conference calls) on its website, links to appropriate risk disclosures should be included so that the written transcript arguably is accompanied by appropriate cautionary language for purposes of the statutory safe harbor for forward-looking statements.

Differentiate from other sites
A company should create a design for its website that differentiates it from any other Internet site about the company maintained by others. A notice can appear when a user leaves the website (by hyperlink or otherwise) thanking the user for visiting the company site and disclaiming responsibility for information in any other site.

Secure the site
A company should implement security protections for its website to ensure that information displayed on the site cannot be altered and additional information cannot be included without the company's knowledge and approval. A number of consulting firms can perform security audits to determine any exposures presented by a company's website practices.

Manage investor relations content
The SEC and the stock exchanges require the posting of certain information on a company's website including a copy of the company's code of ethics (and waivers or amendments to it); insider trading and beneficial ownership reports; quarterly, annual, and current reports filed with the SEC; and other matters. Care should be taken to ensure that all required information is organized, accessible, and updated.

Social media
Social media creates potential problems for companies from a securities law standpoint. Many of the statements made on social media are quite critical, frank, and may not be accurate. Following are several suggestions for minimizing the risk of securities violations associated with social media.

Refrain from responding to rumors
Because companies are generally not required to respond to rumors in the market, they should usually refrain from responding to cyber gossip in any way. That position should be consistently maintained regardless of the rumor. Otherwise, selective responses may effectively confirm or deny certain rumors.

One exception to this blanket policy would be if a third party widely disseminates false information through social media that appears to be issued by or attributable to the company. Because such communications appear to be coming from the company, an immediate disclaimer by the company of the false information is appropriate. In those rare cases where the company feels compelled to respond to social media rumors (either for business reasons or because it has arguably become entangled with the statement made), it should do so only after widely disseminating a press release and, if necessary, filing a Form 8-K with the SEC.

Discourage employee participation
Any statement made on social media by a company employee could be viewed as a disclosure by the company. Therefore, companies should implement policies that prohibit employees from discussing or referencing the company in social media communications. A message sent from a company's email address or from a person identified as an employee may appear to be a communication on behalf of the company. If an absolute prohibition to these disclosures about the company is culturally unacceptable or impractical to enforce, employees should at a minimum be given clear guidelines that proscribe discussions of internal corporate matters, company business, client information, or other confidential business information. Further, employees should always be prohibited from using company computers and identifying themselves as affiliated with the company when making these types of communications.

Monitor social media
Companies should monitor social media communications for company references. Certain service companies sell this service to public companies. Only by knowing the nature and severity of the rumors and statements about the company can executives create an appropriate counterstrategy.

Cybersecurity

Disclosure issues relating to cybersecurity present enormous challenges for directors and officers. Existing law is quite vague on what should be disclosed when in this context. Yet, if a company's cybersecurity disclosures—or lack of disclosures—are later determined to be improper or inadequate, there may be severe consequences to both the company and the responsible directors and officers.

In October 2011, the SEC issued formal guidance regarding a company's disclosure obligations relating to cybersecurity risks and incidents. That guidance did not change existing disclosure law, but merely explained the SEC's interpretation of how existing law relates to the evolving topic of cybersecurity.

The primary focus of the guidance is to assist companies in determining whether they should disclose information concerning cybersecurity and cyber incidents to investors. The ultimate question is whether known cyber incidents or the risk of potential incidents is reasonably likely to have a material effect on the company's operating results or financial condition and thus important to investors (i.e., is the information "material"?). Factors that the SEC suggests a company consider in determining what, if anything, should be disclosed relating to cyber risk prior to a cyber incident occurring include:

- Frequency and severity of prior cyber incidents.
- Probability of cyber incidents' occurring.
- Potential costs and consequences of cyber incidents.
- Adequacy of preventative actions taken.
- Risk level of threatened cyber attacks.

If disclosure is required, the guidance discourages boilerplate disclosures and encourages specific disclosures identifying the portion of the company's operations susceptible to the disclosed cyber risk, any material cyber incidents the company has experienced and the consequences of those incidents, and risks from cyber incidents that may remain undetected for an extended period.

Once a significant cyber event occurs, particularly difficult securities disclosure issues arise. Many companies encounter some form of data breach or other cyber incident regularly. Determining which of those events are "material" for securities law purposes and thus should be disclosed is a highly judgmental decision in many instances. Senior management should carefully evaluate that question with respect to each meaningful cyber incident after obtaining the advice and factual input from appropriate internal staff and qualified external legal counsel and other relevant advisors. Excessive and unnecessary disclosures of actual incidents may convey an inaccurate message to investors, but failing to disclose an incident which is reasonably likely to have a material impact on the company is likewise harmful to investors.

Although cyber-related disclosure issues inherently lack clear answers in many contexts, it is clear that directors and officers need to thoughtfully and thoroughly consider the issues and make informed decisions about what to disclose when. The one certainty in this area is that failure of directors and officers to properly consider the issues dramatically increases the risk of securities law violations.

Climate Change

Climate change is another emerging area of uncertain disclosure rules. Particularly for companies that directly or indirectly cause or are impacted by carbon emissions, investors increasingly want to know what effect existing and future climate change developments may have on the company.

In 2010, the SEC issued formal guidance regarding company disclosures with respect to the business and financial impact that climate change developments may have on a company. That guidance highlighted the following areas as examples where climate change may trigger disclosure requirements:

- **Impact of legislation and regulation:** When assessing potential disclosure obligations, a company should consider whether the impact of existing (and in some circumstances proposed) laws and regulations regarding climate change is material to the company.
- **Impact of international accords:** A company should consider, and disclose when material, the risks or effects on its business of international accords and treaties relating to climate change.
- **Indirect consequences:** Legal, technical, political and scientific developments regarding climate change may create new opportunities or risks for companies.

For instance, a company may face decreased demand for goods that produce significant carbon emissions or increased demand for goods that result in lower emissions than competing products. A company should consider, for disclosure purposes, the actual or potential indirect consequences it may face due to climate change issues.

- **Direct impacts of climate change:** Companies should also evaluate for disclosure purposes the actual and potential material impacts of climate change matters on their current and future business.

This disclosure guidance is admittedly vague, but it emphasizes the importance of companies regularly considering how climate change developments are and likely will continue to affect the company, and thus what, if any, specific disclosures should be made regarding the impact of climate change issues on the company. Advise and input from appropriate internal staff and external advisors can be important in that process.

In response to a perception that many companies and regulators are ignoring climate change issues, a growing number of shareholder resolutions are being adopted which request specific disclosures by the company in connection with climate change issues. Although these resolutions are typically non-binding, they reflect the heightened interest by shareholders in this topic and may constitute a precursor to securities litigation if the requested disclosures are not made or are inaccurate when made. As a result, companies that ignore or carelessly react to these resolutions do so at their own risk.

Initial Public Offerings

Companies and their directors and officers are particularly vulnerable to securities litigation as a result of the company's initial public offering ("IPO") of securities. When privately-held, the company did not need to comply with the SEC's detailed disclosure requirements and likely did not have the culture, policies and procedures necessary to comply with public-company disclosure rules as part of the company's routine business practices. Transitioning into the far more regulated public-company world can be difficult and often results in mistakes which fuel securities litigation.

Before deciding to undertake an IPO, directors and officers should thoroughly understand the consequences of that decision by having lengthy and detailed discussions with experienced legal, accounting and underwriter advisors, as well as with other directors and officers who have successfully navigated that transition. The reality of being a publicly-owned company is far more demanding than the allure of personal gratification and financial rewards from an IPO. Unless senior management is prepared to lead the company through truly significant changes in the company's governance, reporting and operational practices and culture, the IPO should not be pursued.

Because the SEC requirements for public companies are quite onerous, many private companies in the past elected to remain privately-held, thereby foregoing access to significant additional capital and growth opportunities. To address some of those concerns, the Jumpstart Our Business Startups Act ("JOBS Act") was enacted in 2012 and substantially reduces the regulatory burdens of going public for qualifying companies. The JOBS Act generally applies to private companies with up to $1 billion in annual revenue.

Under the JOBS Act, qualifying private companies can undergo an IPO with fewer disclosures and less regulatory oversight. But, the general antifraud provisions of the securities laws still apply. So, disappointed investors who received fewer disclosures during the IPO process as a result of the JOBS Act may have a stronger basis to assert securities claims against the company and its directors and officers. To mitigate that increased exposure, companies should consider voluntarily disclosing in the IPO more information in greater detail than required under the JOBS Act, thereby reducing the ability of shareholders to allege the company failed to disclose material information during the IPO.

Directors and officers of a company involved in an IPO not only must comply with onerous disclosure requirements, but frequently must also comply with restrictions on their personal sale of company securities for a period of time following the IPO. These restrictions can exist under the securities laws or pursuant to lock-up agreements with underwriters for the IPO. Directors and officers should receive a written summary of these restrictions at the time of the IPO and should share that summary with their personal securities broker.

M&A Transactions

Merger and acquisition (M&A) transactions create challenging disclosure issues for directors and officers with respect to when the proposed transaction should be publicly disclosed, what information should be included in that public disclosure, and how the confidentiality of information should be maintained before that public disclosure.

- **Timing of disclosures:** Courts have not identified clear guidelines for determining when a proposed M&A transaction should be disclosed. Premature disclosure of the transaction may jeopardize the negotiation of the transaction and may mislead investors into believing the transaction is likely to occur. On the other hand, delinquent disclosure may harm investors who sell their shares while the secret acquisition negotiations are occurring. Instead of adopting a bright-line rule concerning when the negotiations should be disclosed, courts generally apply a case-by-case analysis that weighs the probability that a transaction will occur and the magnitude of the effects of the transaction. Generally, the higher the probability and the greater the effects, the more likely disclosure is required

  Directors and officers should seek advice from qualified legal counsel regarding this rather subjective, but very important analysis. In addition, to avoid inadvertent mistakes relating to disclosures, all persons involved in the proposed transaction should be informed that all public comments by or on behalf of the company relating to the transaction should occur through a designated spokesperson, who should obtain approval from qualified legal counsel before saying anything. One company to the transaction should coordinate the timing and content of its disclosures with the timing and content of disclosures by the other parties to the transaction so that all public communications by all parties are consistent.

- **Content of disclosures:** Securities litigation relating to M&A transactions typically include claims alleging the defendants misrepresented or omitted material facts regarding the terms, negotiations and impact of the proposed transaction. The proxy materials relating to the transaction should contain a detailed and thorough explanation regarding the history of the directors' consideration of the transaction, the reasons the directors recommend the transaction to shareholders, the terms of the transaction and its financing, the material conditions for closing the transaction, and the likely impact of the transaction to the company and its shareholders.

  For example, the disclosures should describe the content of the fairness opinion from the investment banker, including the valuation methodologies used, the assumptions and projections underlying the analysis and any limitations on the opinion. Also, the disclosures should include a description of factors which could potentially impact the process utilized by the directors or the advice rendered by any of the expert advisors, including financial incentives or other arguable conflicts of interest. These disclosures should include both factors inherent in any acquisition transaction and unique factors applicable to the specific transaction. The more complete and candid the disclosures, the more likely directors and officers will be able to successfully defend disclosure claims by shareholders.

- **Confidentiality:** The number of people with access to information about the proposed transaction should be controlled and limited in order to minimize the risk of selective or improper disclosure of nonpublic information. All such persons should be expressly informed of the strictly confidential nature of the information and forbidden from disclosing that information to any person without prior approval. Non-employee advisors should sign a confidentiality agreement before receiving any information or otherwise becoming involved in the proposed transaction. Similarly, the prospective bidder should sign a strict confidentiality agreement which prohibits the bidder from using or disclosing information about the company, or from disclosing information about the proposed transaction, without the prior consent of the company.

Director's or Officer's Purchase or Sale of Company Securities

The federal securities laws impose various limitations, restrictions, and reporting obligations on directors, officers, and others regarding their purchase and sale of securities of their own company.

The SEC and courts have substantial powers in sanctioning and imposing penalties for violations of these laws. Therefore, a critical component of any securities loss prevention program is the establishment of proper policies and procedures addressing when and how directors, officers and other employees may purchase or sell company securities.

The following discussion summarizes many of the more important laws relating to directors' and officers' purchases and sales of their company's securities, as well as loss prevention practices to minimize the risks relating to those transactions.

Section 16 Issues

Reporting requirements

Section 16 of the Securities Exchange Act of 1934 (1934 Act) generally requires executive officers, directors, and greater-than-10% stockholders of a publicly traded corporation to file certain reports with the SEC, securities exchanges, and their respective corporations disclosing ownership of, and transactions in, the corporation's equity securities. Further, companies are required to disclose, in proxy materials and Form 10-K, the names of officers, directors, and greater-than-10% stockholders who have failed to file required reports on a timely basis. To avoid the need to make such potentially embarrassing disclosures and to avoid liability concerns, it is particularly important that officers and directors understand and comply with SEC reporting requirements in this context.

Disgorgement of profits

In addition to detailed reporting requirements, Section 16 also contains the so-called "short-swing trading" provision, which requires that any profit realized by an executive officer, director, or greater-than-10% stockholder from any purchase-and-sale or sale-and-purchase of any equity security of the company within any six month period must be disgorged to the company. Unlike most other provisions in the federal securities laws, intent to take unfair advantage of nonpublic information is not required for recovery under Section 16(b). In other words, transactions in the company's securities within six months of one another can lead to disgorgement of profits on the transaction irrespective of the reasons for or purposes of the transaction.

It is irrelevant for Section 16(b) purposes whether the purchase or the sale comes first. Furthermore, the courts will match the lowest purchase price with the highest sale price. Thus, although the officer or director may have realized an economic loss, he or she may be treated under Section 16(b) as having realized a "profit" for purposes of the disgorgement rules.

Potential profit disgorgement also may apply to transactions in derivative securities. For example, the purchase of a call option on the company's stock and a sale of either the option or shares of the company's stock within six months would be subject to potential profit disgorgement under Section 16(b). Employee stock options that are not properly structured are the most common form of derivative security that can potentially lead to inadvertent violation of Section 16(b).

Most violations of Section 16 are not discovered by the company or the SEC. Instead, Section 16 violations are actively policed by a small group of plaintiffs' attorneys who actively monitor filings made with the SEC, looking for trades that are not consistent with the rules. Like other types of securities claims, in many cases the sole stimulus for the enforcement of Section 16(b) is the pursuit of plaintiffs' attorney fees.

Prohibition of short selling
Section 16(c) of the 1934 Act prohibits any officer, director, or greater-than-10% stockholder from engaging in a "short sale" of company stock, pursuant to which the seller

realizes a profit only if the stock price goes down in the future. The prohibition against directors and officers engaging in short sales arose out of the inherent and undeniable conflict between a director's or officer's goal of enhancing the company's stock for the benefit of all shareholders, and his or her personal benefit through the short sale from a stock price decline. Particularly difficult questions can arise in the application of Section 16(c) to certain derivative security transactions. As a result, directors and officers should avoid not only classic short sales, but also avoid options or other derivative trading involving company securities.

Section 16 compliance program

Because of these various requirements, a company should adopt a program to assist executive officers and directors in their compliance with Section 16. This compliance program could include the following components:

- The company should designate one person (typically someone in the Investor Relations or Legal Departments) to act as its compliance officer for these purposes. The compliance officer should be trained in Section 16 matters by a knowledgeable securities lawyer and should be required to obtain, read, and refer to some of the materials widely available on the topic.
- All executive officers and directors should receive a written summary of their responsibilities and the applicable prohibitions and requirements under Section 16.
- Each executive officer and director could be required to sign an agreement with the company to report all transactions in the company's securities to the company prior to, or contemporaneously with, any transaction in the company's securities.
- Each executive officer and director could be required to

"pre-clear" each transaction involving the company's securities with the compliance officer to ensure adherence to the company's compliance program.
- Each executive officer and director could be required to sign a power of attorney authorizing the company's compliance officer to sign and file, on behalf of the officer or director, the necessary SEC forms.
- A "Short Swing Profit Rule 16(b) Checklist" could be distributed to each executive officer and director, summarizing the relevant facts that should be considered prior to a purchase or sale of company securities by the director or officer and procedures that should be followed after any such transaction.
- Directors and officers could be encouraged to utilize the services of a single knowledgeable broker to assist in helping to prevent inadvertent short-swing profit and filing violations. By utilizing a single broker, the company's compliance officer could more clearly coordinate with that broker to ensure compliance with the company's policies.
- The company could periodically (but regularly) hold a brief executive review session with its directors and officers to go over the various SEC requirements, review any problems that may have arisen, answer common questions, and highlight common pitfalls.

1933 Act Issues

Under the Securities Act of 1933 (1933 Act), directors and most officers (among others) may not sell securities of the company unless the sale is covered by a 1933 Act registration statement or such sale is made pursuant to an exemption from the registration requirement. The usual exemption relied on by directors and officers is Rule 144 under the 1933 Act, which, among other conditions, generally requires that restricted securities acquired other than in the open market must be held for at least one year and any sales of those securities must be made through transactions with broker- dealers and otherwise comply with detailed rules. It is important that the broker-dealer through whom or to whom the director or officer is selling securities be informed that the securities are being sold pursuant to Rule 144.

Directors and officers should be informed in writing of these restrictions and advised that noncompliance may result in personal liability.

Insider-Trading Restrictions

In the course of their employment with the company or its subsidiaries, officers, directors, and employees frequently come into possession of confidential and highly sensitive information concerning the company, its customers and suppliers, or other companies with which the company has contractual relationships or may be negotiating transactions. Much of this information has a potential for affecting the market price of securities issued by the companies involved. Under some circumstances, the federal securities laws impose onerous civil and criminal penalties, as well as personal liability on persons who improperly use material nonpublic information in connection with a purchase or sale of securities.

Individuals violate the laws prohibiting insider trading not only if they personally trade in a company's securities while in possession of material non-public information, but also if they disclose the information to another person in exchange for some type of personal benefit and that other person then trades in the company's securities. The requisite “personal benefit” for this purpose may include gaining a “reputational benefit” or other non-monetary benefits, or gifting the information to a close friend or relative. To avoid this liability exposure, insiders should refrain from disclosing to anyone outside the company (including spouses, children and close friends) any material non-public information.

Persons potentially liable for illegal insider trading include not only the insider who misuses the inside information, but also certain persons who, at the time of an insider-trading violation, “directly or indirectly controlled the person who committed such violation,” i.e., an employer or superior officer or director. Any “controlling person” may be liable for civil penalties if the controlling person both 1) knew or recklessly disregarded the fact that the employee was likely to engage in a violation and 2) failed to take appropriate steps to prevent that violation before it occurred.

The SEC and governmental prosecutors vigorously enforce the insider-trading laws against both individuals and institutions. It is critical that a company and its directors, officers, and employees understand, comply with, and adopt policies and procedures to protect against violations of the insider-trading laws. These programs typically educate insiders about applicable legal prohibitions and frequently require the written permission of the company’s general counsel before the insider can trade in company securities. For corporations that are larger or feel particularly vulnerable to the prospects of insider trading, a more aggressive risk management practice could be implemented whereby corporate insiders are permitted to trade in company securities only during certain predetermined “windows” of time throughout the year. Generally, these window periods are timed to occur just following the announcements of quarterly or annual results, at a point when the marketplace has presumably absorbed the recent announcement, but no new nonpublic material developments have occurred. These trading windows can typically be closed by the company's general counsel if it is perceived that other material nonpublic information may exist.

"Blind trusts" can also be established for senior executives who constantly are in possession of material non-public information. Under this arrangement, an independent trustee implements purchase and sale transactions for the benefit of the insider without any direction or input from the insider. The transaction could be either in accordance with a predetermined schedule or at the discretion of the trustee.

The most common blind trading arrangement is a so-called 10b5-1 plan, which is a written plan pursuant to which automatic purchases or sales of the company's securities will occur at predetermined amounts, prices, or dates. The plan should not permit the director or officer to exercise subsequent influence over how, when, or whether to effect the transactions or to alter or deviate from the plan in any way. Some best practices when creating and adopting a 10b5-1 plan include the following:

- Implement the plan for a director or officer at a time when the director or officer is not in possession of material non-public information.
- Require a waiting period before the first trade under the plan.
- Avoid multiple and overlapping plans for the same individual.
- Prohibit the director or officer from altering or

changing the plan at his or her discretion.
- Use relatively simple criteria for determining when trades occur and the amount of securities traded.

Simply having a written policy against insider trading in many cases will not shield the company or its directors and officers from liability. The SEC will look behind the policy to see how it has been implemented and whether there were any red flags to indicate that the policy was not being enforced or was ineffective on its face to deal with the kinds of situations the company knew or should have known were taking place. In other words, for any adopted 10b5-1 plan to be effective, it must be broadly disseminated, actively monitored, and aggressively enforced.

Whistleblowers

Both the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumers Protection Act of 2010 contain provisions which encourage persons with non-public information about a company's securities law violations or other illegal activities ("whistleblowers") to disclose to the SEC that wrongdoing. If a whistleblower provides information that results in the SEC recovering penalties or damages for the illegal activity, the whistleblower is entitled to receive as a "bounty" a portion of the SEC's recovery. In addition, the company is prohibited from retaliating against the whistleblower for providing the information to the SEC. As a result, employees and others with access to company information (such as the company's auditor, lawyer or other advisor) are heavily incentivized to provide potentially harmful information to the SEC, thereby significantly enhancing the likelihood of securities litigation.

To counter those strong whistleblower incentives, it is extra important that companies maintain an internal reporting system which encourages employees and others to seek remedies for identified wrongdoing internally within the company rather than through an external regulator. This internal reporting system should be available for use by current and former employees as well as other third parties, should be strictly confidential, should encourage persons to make reports without fear of retribution, should ensure a thorough and independent investigation of all reports, and should accommodate complaints against persons within the reporting structure. Although many reported complaints in such an internal reporting system typically are related to personnel issues rather than securities law or other legal compliance issues, these employment-related whistleblower disclosures frequently are the best source for identifying other more serious legal compliance issues. So, this internal reporting system should be a well understood and trusted method for persons to report wrongdoing. Investigating the reports can be challenging because the most serious violations are frequently reported anonymously, but those challenging investigations are at times the most important.

The persons involved in operating the internal reporting process should have direct access to the company's general counsel, chief compliance officer and ultimately the chair of the appropriate Board committee so that all compliance situations will be considered by disinterested persons within the company.

Conclusion

Liability for securities law violations is the severest exposure a public company executive is likely to encounter. A highly effective plaintiffs' bar and sophisticated regulators in this area assure that perceived securities law violations by directors and officers will likely be aggressively pursued. While this booklet discusses some of the steps a company can implement to control its risk of securities litigation, no set of practices and procedures can substitute for an active and aware management team that seeks and follows the advice of experienced legal, financial, technical, and insurance professionals.

About the Author

Dan A. Bailey, Esq., a member of Bailey Cavalieri LLC in Columbus, Ohio, is one of the nation's foremost experts on matters relating to directors and officers (D&O) liability, litigation, and insurance. He and his firm have represented or served as a consultant to a wide variety of directors and officers, corporations, insurance companies, insurance brokers, and law firms around the country regarding D&O matters.

A frequent speaker at seminars throughout the country regarding D&O liability and insurance, Mr. Bailey is also the co-author (with William E. Knepper) of Liability of Corporate Officers and Directors (8th edition, 2017), and he has written dozens of articles on the subject.

Mr. Bailey received his B.S. degree in business administration cum laude from Bowling Green State University in 1975 and was awarded a Juris Doctorate degree with honors from the Ohio State University School of Law in 1978. He is a member of numerous honoraries and was selected for inclusion in *Who's Who in America*.

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