WILMER, CUTLER & PICKERING

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SEC'S FIRST REGULATION FD ENFORCEMENT CASES HIGHLIGHT IMPORTANT ISSUES

The SEC on November 25, 2002 announced the conclusion of its first set of enforcement matters under Regulation FD. The rule, effective since October 23, 2000, prohibits issuers from selectively disclosing material information to investment professionals. The facts underlying the four enforcement matters brought by the SEC and the SEC's analysis of these matters provide substantial insight into the SEC's attitude toward enforcement of Regulation FD. This newsletter briefly discusses the background of Regulation FD, summarizes the four enforcement matters and notes implications and recommendations for issuers.

I. Background of Regulation FD

The SEC adopted Regulation FD as a response to a perception that issuers privately communicated material information to investment professionals without simultaneously disclosing the information to the public.[1] Under the rule, whenever an issuer discloses material nonpublic information to securities industry professionals or holders of the issuer's securities who may trade on the basis of the information, the issuer must make public disclosure of the same information (1) simultaneously for intentional disclosures or (2) promptly for non-intentional disclosures.[2] A disclosure is non-intentional if the issuer was not aware (and was not reckless in not being aware) that the information was material or that the information had not previously been publicly disclosed.[3]

In adopting Regulation FD, the Commission stated that "issuers will not be second-guessed on close materiality judgments."[4] Several days after Regulation FD became effective, the Director of the Division of Enforcement stated that the rule "was *not* designed as a trap for the unwary."[5] The SEC indicated that it would only institute proceedings when it became aware of substantial violations concerning clearly material information.

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1 *See Selective Disclosure and Insider Trading*, Exchange Act Release No. 43154, 65 Fed. Reg. 51,716 (Aug. 24, 2000) ("*Adopting Release*").

2 *See* Rule 100 of Regulation FD, 17 C.F.R. §243.100.

3 *See* Rule 100(b)(1)(iv).

4 *Adopting Release* at 51,718.

5 Richard H. Walker, Director of the Division of Enforcement, Securities and Exchange Commission, *Regulation FD-An Enforcement Perspective*, Speech before the Compliance & Legal Division of the Securities Industry Association (Nov. 1, 2000) *available at* http://www.sec.gov/news/speech/spch415.htm.

II. Description of Enforcement Matters

The four matters announced by the SEC involved Raytheon,[6] Siebel Systems,[7] Secure Computing Corporation[8] and Motorola.[9] In Raytheon and Secure Computing, the SEC also brought proceedings against an officer of the issuer.

A. Factual Background of the Proceedings

Raytheon. Raytheon[10] related to discussions of earnings estimates between the company and investment professionals. In early February 2001, Raytheon reiterated the company's earnings estimates for the entire year but did not, consistent with company practice, provide quarterly estimates. After the February disclosure, Raytheon's CFO instructed his staff to compile data on analyst models for Raytheon's quarterly earnings. Raytheon determined that most analysts estimated that Raytheon would generate more of its earnings in the first half of the year than Raytheon itself expected.

In mid February and early March, the CFO contacted eleven of thirteen sell-side analysts covering Raytheon and told the analysts that Raytheon expected the distribution of its earnings would follow the same seasonal pattern as in prior years; i.e., that earnings would be lower in the first and second quarters than the analysts were projecting. After these discussions, the analysts generally lowered their estimates for Raytheon's first quarter.

Siebel. Siebel involved the company's discussion of earnings at a private technology conference. Prior to the conference, Siebel issued a public earnings release in October 2001, stating that "things will be quite tough through the remainder of the year." At the technology conference in late November 2001, however, Siebel's CEO responded to a question about the company's internal "sales pipeline" by indicating that the company was "optimistic" and that he believed sales were "returning to normal." Siebel had not previously made any public statements indicating that results would be better than predicted in the October release.

Siebel's CEO had received talking points from Siebel's investor relations director, which were prepared specifically to help ensure that no material, nonpublic information was disclosed at the conference. The talking points did not include an outlook on sales and the CEO's remarks on this point went beyond the talking points. The CEO believed that the conference would be webcast. Although the company's investor relations officer knew otherwise, the officer failed to clarify this fact in a discussion with the CEO just prior to the conference. During and immediately after the conference, attendees and individuals contacted by them purchased shares of Siebel. The company's share price and volume increased substantially by the end of the day.

Secure Computing. Secure Computing's selective disclosure related to an inadvertent statement to investment professionals regarding a material contract followed by an intentional selective disclosure the next day. Secure Computing had entered into an agreement to sell a product as an Original Equipment Manufacturer (OEM) to one of the nation's largest computer networking companies. Secure Computing had agreed that it would not make a public announcement regarding the contract without the other party's consent.

On March 6, 2002, prior to publicly announcing the contract, Secure Computing's CEO spoke with a portfolio manager and a salesperson at a brokerage firm. During the conversation, the CEO asked the company's investor relations director (who was also on the call) if it was permissible to "discuss something that had been posted on the company's" website.[11] The investor relations officer responded affirmatively and did not realize until later in the

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6 *In the Matter of Raytheon Company and Franklyn A. Caine*, Exchange Act Release No. 34-46897 (Nov. 25, 2002) ("*Raytheon*").

7 *In the Matter of Siebel Systems, Inc.*, Exchange Act Release No. 34-46896 (Nov. 25, 2002) ("*Siebel*").

8 *In the Matter of Secure Computing Corporation and John McNulty*, Exchange Act Release No. 34-46895 (Nov. 25, 2002) ("*Secure Computing*").

9 *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Motorola, Inc.*, Exchange Act Release No. 34-46898 (Nov. 25, 2002) ("*Motorola*").

10 These matters involved settlements or reports in which the respondents neither admitted nor denied the SEC's allegations or findings.

11 *Secure Computing* ¶ 11. The website information was posted for the use of the OEM buyer's sales force and did not disclose the OEM agreement itself.

call that the CEO was referring to this contract. After the call, the investor relations officer advised the CEO that disclosure of the contract was inappropriate, and Secure Computing determined that it must promptly make a public announcement. Secure Computing could not, however, obtain prompt approval of a public announcement from the other party to the agreement.

On March 7, 2002, before a public announcement of the agreement could be made, Secure Computing's CEO spoke with an institutional investor concerning rumors about the agreement. The CEO confirmed the existence of the deal even though it had not been publicly disclosed. Secure Computing's share price and volume increased substantially on March 6 and 7, 2002.

Motorola. Similar to Raytheon, Motorola's selective disclosure involved private discussions of earnings information between the company and investment professionals. On February 23, 2001, Motorola issued a press release stating that it did not expect to meet its previous guidance for first quarter sales "as a result of significant weakness" in its business segments. Although most analysts lowered their first quarter earnings estimates as a result of this announcement, Motorola concluded that the analysts' estimates were generally still too high.

Motorola's investor relations officer then called 15 analysts to discuss their estimates. In these calls, the investor relations officer specifically told the analysts that Motorola uses the term significant to mean 25% or more. Each of the analysts contacted revised its estimate downward. During the period the calls were made, Motorola's share price dropped 15%.

Prior to making these calls, the investor relations officer consulted with Motorola's in-house counsel responsible for SEC reporting and disclosure issues and asked whether it was permissible to provide the specific quantitative definition (25%) for the qualitative designation (significant). Counsel concluded that the information could be given because the definition was not material and because counsel believed that the definition had already been made public.

B. SEC's Conclusions with Respect to the Matters

The SEC found that Raytheon, Motorola, Siebel and Secure Computing had all made intentional selective disclosures of material nonpublic information. The SEC reached settlements with Raytheon, Siebel and Secure Computing in which each of the issuers and the named officers at Raytheon and Secure Computing consented to entries of administrative orders without admitting or denying the allegations against them. Each of the parties agreed to cease and desist from violations of Regulation FD. In addition, Siebel paid a fine of $250,000. One Commissioner dissented as to the lack of penalties in *Secure Computing* and *Raytheon* while two Commissioners dissented as to the fine against Siebel.

The SEC did not institute proceedings against Motorola. Rather, the SEC issued a report of investigation, primarily due to the fact that the company involved securities counsel prior to making the selective disclosure.[12] The SEC explained that it did not institute a proceeding against Motorola because Motorola obtained legal advice, which was sought and given in good faith.

The SEC did not explicitly state why it imposed a fine on Siebel in addition to the cease and desist order, and there were no clear differences between the SEC's findings in *Siebel* and the other matters that would explain the dissimilar treatment. The SEC also did not explain why no individual officers at Siebel were named as parties to the action, though it may be that the Commission concluded that the officer making the disclosure acted in a good faith belief that the statements were being webcast.[13]

III. Implications and Recommendations for Issuers

The underlying circumstances and the SEC's findings in the four enforcement matters illuminate several important factors regarding the SEC's views with respect to its enforcement of Regulation FD.

- *Earnings Guidance.* Three of the matters explicitly involved statements related to

[12] Section 21(a) of the Securities Exchange Act of 1934 authorizes the SEC to issue such a report, which is not an adjudication of any fact or issue in the report.

[13] Because the investor relations officer knew that the conference was not webcast, the issuer as an entity presumably was not able to rely on the exception for inadvertent disclosures.

earnings guidance. In adopting Regulation FD, the SEC stated that if issuers selectively disclose earnings guidance to analysts "the issuer likely will have violated Regulation FD."[14] These three matters demonstrate this risk in stark detail. In each of these matters, arguments could be made that the information disclosed was not material. In *Motorola*, the issuer believed the quantitative information disclosed was not material because it merely clarified publicly disclosed qualitative information. In *Raytheon*, the privately disclosed information provided detailed (quarterly) information consistent with the more general (annual) information publicly disclosed. In *Siebel*, the information disclosed related to the general condition of the issuer's business rather than specifics relating to earnings. But in each case, the SEC found the information material. Although the Regulation FD adopting release indicates that earnings guidance is not "per se material," these cases demonstrate that the SEC sets a high bar for demonstrating that earnings guidance is not material. Issuers should therefore continue to exercise a great deal of caution when making private statements relating to earnings estimates.

- *Material Contracts.* The fourth matter did not deal with earnings guidance, but rather a material contract. The SEC did not discuss the factors that led it to conclude that the contract involved in *Secure Computing* was material, although Secure Computing itself apparently acknowledged the materiality of the contract in determining that it had to make public disclosure once the existence of the contract had been selectively disclosed.

- *Effect of Stock Price Movement.* In each of the four matters, the SEC noted the proximity of each company's selective disclosure with changes in share price and volume.[15] Although the SEC has described the use of significant market changes in stock price alone as "too blunt an instrument" to be a reliable indicator of materiality,[16] these cases demonstrate once again that stock price movement will be a key determinant of materiality. Issuers should therefore continue to take extra precautions if they believe that disclosure of information may significantly affect stock prices.

- *Corporate Liability.* *Siebel* demonstrates that a corporation or other entity may be liable even if individuals making the disclosure acted in good faith. Siebel's CEO apparently believed in good faith that the technology conference at which he disclosed material information was webcast. At the same time, the company's investor relations officer had prepared talking points designed to keep the CEO from disclosing non-public material information. Nevertheless, the SEC found that "the IR Director, *and therefore, the Company*, knew that the [conference] would not be webcast" and the company was therefore culpable.[17] *Siebel* therefore points out that even though an individual acts in good faith, if another representative of the company knows of a violation and does not take action to stop the other individual, the issuer may be liable.

These matters and the implications noted above suggest several actions issuers should take to avoid violations of Regulation FD or mitigate the effects of violations. Although most of the actions below have been widely recommended since the adoption of the new rule, the enforcement matters drive home their importance.

- *Consult Counsel.* *Motorola* clearly demonstrated the value of consulting counsel on Regulation FD matters. The principal factor in the SEC's decision not to institute proceedings against Motorola was the company's pre-disclosure consultation with counsel. Although the SEC encourages consulting securities counsel, the SEC clearly stated that this alone will not automatically avoid liability.

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[14] *See Adopting Release* at 51,721.

[15] The SEC noted that Siebel's share price increased by 16% on approximately double normal trading volume, Secure Computing's stock price rose 7% on 130% higher volume, Raytheon's Series B common stock declined 6%, and Motorola's stock dropped 15%.

[16] *See* Staff Accounting Bulletin No. 99 - Materiality (Aug. 12, 1999) (quoting Financial Accounting Standards Board, *Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information*, 169 (1980)).

[17] *See Siebel* ¶ 5 (emphasis added).

In particular, the SEC noted that a consultation with counsel would not protect an issuer that did so only to provide "cover" for an action it would take regardless of the counsel's advice, or if the issuer did not give counsel sufficient information on which to make an informed judgment.

- *Obtain explicit confidentiality agreements where appropriate.* Regulation FD permits disclosure of material nonpublic information if the recipient of the information explicitly agrees to maintain the confidentiality of the information until it is publicly disclosed.[18] In *Secure Computing*, after disclosing the nonpublic information regarding the OEM agreement and before publicly disclosing the information, the issuer "requested that the information be kept confidential."[19] Although it is not clear that a confidentiality agreement would have cured the prior disclosure, the fact that there was only a request and not an express agreement rendered this action ineffective as a defense. Issuers should seek an express agreement to maintain the confidentiality of information whenever possible, including if there has been an inadvertent disclosure.

- *Stick to scripts and talking points.* In *Siebel*, the investor relations director had prepared talking points specifically to avoid selective disclosure, but the combination of confusion about whether remarks were webcast and a deviation from the talking points resulted in a violation. Officers of issuers should stick to talking points, and if they expect to deviate from them any deviation should be discussed in advance.

- *Make prompt corrective disclosure.* Although Siebel's CEO believed that the conference was webcast, the company consented to a $250,000 fine. In contrast, Secure Computing's CEO's second disclosure of Secure Computing's material contract was clearly intentional but did not result in a fine. The SEC may have credited Secure Computing's recognition of the violation and efforts to publicly announce the agreement after the inadvertent disclosure. Issuers should take advantage of the flexibility in Regulation FD related to inadvertent disclosure by making corrective disclosures where appropriate.

It is clear from the three proceedings and report that the SEC will enforce Regulation FD in cases where issuers selectively disclose earnings guidance and other material nonpublic information. If you have any questions concerning Regulation FD, please contact any of the following:

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[18] *See* Rule 100(b)(2)(ii).

[19] *See Secure Computing* ¶ 16.

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