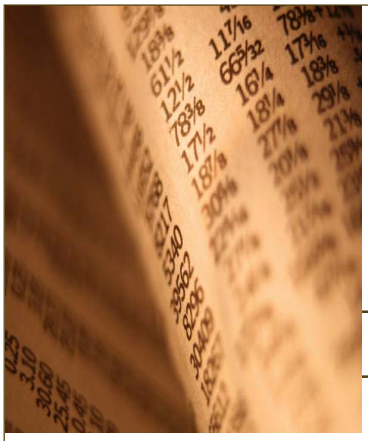

WILMER, CUTLER & PICKERING

Corporate and Securities Law Developments NEWSLETTER

OCTOBER 2, 2003

SEC Hits Hard in Latest Regulation FD Enforcement Case

On September 9, 2003, the SEC announced a Regulation FD settlement with Schering-Plough Corporation and its former chairman and CEO.[1] This settlement is the first Regulation FD enforcement case since November 2002 when the SEC announced its first group of Regulation FD enforcement actions.[2] The SEC alleged, among other things, that Schering-Plough privately told analysts that earnings were going to come in below street estimates. In its complaint and cease and desist order, the SEC emphasized the importance of demeanor and tone in private meetings, as well as the difference between public guidance that is conditional or qualified, and private guidance that is more definitive.

I. Regulation FD

The SEC adopted Regulation FD in August 2000 to address what it understood to be a widespread issuer practice of privately communicating material information to analysts without simultaneously disclosing the information to the general public.[3] 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.[4] 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

[1] *SEC v. Schering-Plough Corp.*, Litigation Release No. 18330 (Sept. 9, 2003), available at http://www.sec.gov/litigation/litreleases/lr18330.htm; *In re Schering-Plough Corp.,* Exchange Act Release No. 34-48461 (Sept. 9, 2003), available at http://www.sec.gov/litigation/admin/34-48461.htm.

[2] *See In re Raytheon Co.*, Exchange Act Release No. 34-46897 (Nov. 25, 2002); *In re Siebel Systems, Inc.*, Exchange Act Release No. 34-46896 (Nov. 25, 2002); *In re Secure Computing Corporation*, Exchange Act Release No. 34-46895 (Nov. 25, 2002); *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). These cases are available at http://www.sec.gov/litigation/admin/adm4q02.shtml and http://www.sec.gov/litigation/investreport/34-46898.htm. For a discussion of these cases, see our Corporate and Securities Law Developments Newsletter dated January 16, 2003, available at http://www.wilmer.com/post/news_items/CorpSecNews01-16-03.pdf.

[3] *See Selective Disclosure and Insider Trading*, Exchange Act Release No. 34-43154 (Aug. 24, 2000).

[4] *See* Rule 100 of Regulation FD, 17 C.F.R. § 243.100.

disclosed. An issuer may, however, privately disclose material nonpublic information if the recipient is obligated to keep the information confidential and the recipient therefore faces potential insider trading liability for any trading based on the information.[5]

II. Overview of the Schering-Plough Case

In late September 2002, internal Schering-Plough managers briefed Richard Kogan, Schering-Plough's then chairman and CEO. The briefings reviewed the latest internal earnings forecasts for the remainder of 2002 and the preliminary forecast of earnings per share for 2003. Both the 2002 and 2003 forecasts were well below current Wall Street analyst estimates. Soon after the internal briefings, Kogan and Schering-Plough's senior vice president of investor relations met privately with analysts and portfolio managers from four firms: Wellington Management Company, Massachusetts Financial Services Company, Fidelity Management & Research Company and Putnam Investments. At the time of the meetings, Wellington, Fidelity, and Putnam were three of Schering-Plough's largest investors.

According to the SEC, during the private meetings, Kogan said that 2003 would be a difficult year, revenues would shrink meaningfully, and earnings would take a hard hit. The SEC compared these definite statements with Schering-Plough's public disclosures, which stated that financial results may suffer depending on various contingencies. Kogan also said that he was opposed to company repurchases of its own shares, while Schering-Plough's public disclosures stated that no decision had been made on whether to repurchase its stock. The SEC concluded that these statements violated Regulation FD because they were materially different from Schering-Plough's public disclosures and they conveyed a "definitive, as opposed to a contingent, statement not previously disclosed."

Kogan also stated during the meetings that there were no cost cutting measures planned for 2003 and that gross margins would be negatively impacted by increased manufacturing expenses and the sale of more products on which royalties were paid. The SEC concluded that although Schering-Plough had disclosed that these factors had increased costs during the second quarter of 2002, the statements made at the meeting went "materially beyond the company's prior public disclosure" since no public disclosure had been made regarding the continuation of this trend into 2003. Kogan also indicated in the meetings that Wall Street's estimates for the third quarter of 2002 were too high and had not been sufficiently lowered to reflect recent events. Although Schering-Plough had publicly stated that it expected third-quarter earnings to be "significantly lower than the comparable period in 2001," it had not publicly commented on Wall Street earnings estimates for the quarter.

The SEC placed a great deal of weight on the conclusions that the portfolio managers and analysts drew from the meetings, and in particular, their comments on Kogan's demeanor and tone. One analyst in attendance downgraded Schering-Plough stock based, in part, on Kogan's "downbeat" demeanor and the amount of time he spent discussing risks to earnings, while another analyst downgraded the stock after perceiving a negative tone. Another portfolio manager in attendance sold the stock based, in part, on Kogan's tone and low confidence level. The SEC repeated its view that one can violate Regulation FD by communicating information about earnings "through indirect 'guidance,' the meaning of which is apparent though implied." As the SEC explained in its November 2002 Section 21(a) Report about Motorola's alleged Regulation FD violations, "Issuers may not evade the public disclosure requirements of Regulation FD by using 'code' words or 'winks and nods' to convey material nonpublic information during private conversations."

[5] *See* Rule 100(b)(2)(i), (ii), 17 C.F.R. 243.100(b)(2)(i), (ii).

Following these meetings, Schering-Plough's stock price fell by more than 17 percent over a period of three days, on more than four times average trading volume. The market reaction was primarily the result of large sales by the four investment advisers whose analysts and portfolio managers had met with Kogan, with sales by two of the advisers accounting for more than 30 percent of the overall market volume during the sell-off.

Several days after Kogan's private meetings, Schering-Plough held a meeting with analysts and portfolio managers at its offices. The meeting was not webcast or otherwise accessible to the public. During that meeting, Kogan said that 2003 would be a tough year and earnings would be "terrible." He also said that gross margins would suffer in 2003 due to royalty and manufacturing expenses. The SEC found that these statements went materially beyond the company's prior public disclosures. Later that day, Schering-Plough issued a press release providing earnings guidance for 2002 and 2003 that was materially below Wall Street estimates and, with regard to fiscal year 2002, materially below previously released earnings guidance.

The SEC concluded that Schering-Plough violated Regulation FD and that Kogan caused the violations by disclosing material, nonpublic information about Schering-Plough's earnings during private meetings, without publicly disclosing the information. The SEC stated that Kogan's "statements, demeanor and general expressions of concern for Schering-Plough's prospects" during private meetings with analysts and portfolio managers constituted selective disclosure that caused those present to sell a substantial amount of Schering-Plough's stock.

In settling the action, Schering-Plough agreed to pay a $1 million civil penalty, Kogan agreed to pay a $50,000 civil penalty, and both agreed to cease and desist from commiting or causing future Regulation FD violations.

III. Analysis

- ***Demeanor and Tone.*** The SEC emphasized that the violations of Regulation FD resulted not just from what was said at the meetings but also from Kogan's "tone, emphasis and demeanor." This suggests that issuers must be careful about nonverbal signals that they convey in private meetings and conversations.

- ***Definitive Statements.*** The SEC noted several times that Kogan made definitive statements that violated Regulation FD because they went beyond prior public statements that were contingent or qualified. An executive who discloses any information in a private setting should be careful to use similar language to that used in public disclosures, and should be careful to include all applicable qualifying terms or statements.

- ***Penalties.*** The $1 million civil penalty paid by Schering-Plough is the largest penalty to date for a violation of Regulation FD, and the $50,000 penalty paid by Kogan is the first fine paid by an individual for an FD violation. In the November 2002 FD enforcement actions, only one issuer paid a penalty, which at $250,000, was significantly lower. The SEC may have been influenced in this case by the significant market impact of the disclosures (a 17 percent price drop in 3 days on 4 times normal trading volume), and the extent, number, and nature of the selective disclosures. The size of the penalties also reflects the generally steep recent upward trend in penalties and other remedies demanded by the SEC in settlements.

- ***The Investment Advisers Did Not Violate Regulation FD.*** The SEC did not charge any of the investment advisers or

individuals who received and benefited from the selective disclosures. Senior SEC officials have warned that, while compliance with Regulation FD is an issuer responsibility, it is possible for others, including recipients of selective disclosures, to aid and abet or cause a Regulation FD violation by pressuring an issuer to make a prohibited selective disclosure.[6] This case confirms that mere receipt and use of selectively disclosed material information does not violate the law. In this important respect, Regulation FD is different from insider trading. Under insider trading law, one who privately receives material nonpublic information from a company insider may not trade if the insider conveyed the information in breach of a duty (*i.e.*, for the insider's personal benefit), for example to enable a friend or family member to reap windfall trading profits, or if the insider asked the recipient to keep the information confidential.

This case shows that the SEC continues its vigorous enforcement of Regulation FD, and may assess large penalties against both issuers and the executives who cause violations. If you have any questions about this enforcement case or Regulation FD, please contact any of the following:

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[6] *See* Speech by SEC Staff: Regulation FD – An Enforcement Perspective, Richard H. Walker Director, Division of Enforcement, Before the Compliance & Legal Division of the Securities Industry Association (Nov. 1, 2000), available at http://www.sec.gov/news/speech/spch415.htm.